EBA/CP/2014/08
12 June 2014
Consultation Paper
Draft Regulatory Technical Standards on assessment methodologies for the Advanced Measurement Approaches for operational risk under Article 312 of Regulation (EU) No 575/2013

Dear Sirs

Introduction

The British Bankers' Association ("BBA") is the leading association for UK banking and financial services for the UK banking and financial services sector, speaking for over 220 banking members from 60 countries on the full range of the UK and international banking issues. All the major banking players in the UK are members of our association as are the large international EU banks, the US banks operating in the UK and financial entities from around the world. The integrated nature of banking means that our members are engaged in activities ranging widely across the financial spectrum encompassing services and products as diverse as primary and secondary securities trading, insurance, investment banking and wealth management, as well as deposit taking and other conventional forms of banking.

The BBA is pleased to respond to this consultation on the draft RTS.

Summary comments

The development of an AMA to calculate the minimum capital requirement for an institution is a significant undertaking and presents many challenges. It is a contributory reason why it is only the largest institutions and banking groups and also very few event attempt the task, and still few are successful in obtaining approval from their competent authorities to use the approach,

That is why in principle we are supportive of the EBA attempt to establish a set of standards to introduce harmonisation of the conceptual approach to modelling Operational Risk.

We note that much of the content builds on the work published previously by CEBS [1]. However, we do not believe that the RTS has gone far enough to embrace the regulations and guidance that is already in place outside the EU that for many of our members (and other institutions throughout the EU) has a significant bearing on the development of AMA models for use in their group,

In the process of articulating this response, we have had input to and agree with the comments set out in the EBF response.

[1] CEBS Guidelines 'Guidelines on the Implementation, Validation and Assessment of Advanced Measurement Approaches (AMA)

Summary of the response to the EBA questions for consultation

Q1: Are the provisions included in these draft RTS on the assessment methodologies for the Advanced Measurement Approaches for operational risk sufficiently clear? Are there aspects that need to be elaborated further?

> No: The draft RTS is not clear. There are many aspects that need to be revised and elaborated as set out in the attached detailed response

Q2: Do you support the treatment under an AMA regulatory capital of fraud events in the credit area, as envisaged in Article 6?
Do you support the phase-in approach for its implementation as set out in Article 48?

> The EBA propose to mandate that fraud risk must be modelled in an AMA model. We reject completely this proposal. We do not support the proposals.
>
> To mandate such a change has significant ramifications for all EU institutions who already have an AMA model and or are in the process of developing an AMA model (with the exception of any institution that has already adopted this choice). It creates inconsistency with non-EU jurisdictions. Its inclusion in the RTS is inappropriate.
>
> We believe the regulation Article 322 (3) (b) that allows an institution to choose its approach to setting the modelling and thus measurement of risk boundary between the calculation of own funds requirements for Credit risk (Title II Capital Requirements for Credit Risk (Articles 107 – 191) and Operational risk (Tile III) should remain.
>
> Therefore, we do not support the phase-in approach.

Q3: Do you support the collection of ’opportunity costs/loss revenues‘ and internal costs at least for managerial purposes, as envisaged in Article 7(2)?

> Yes for management. But no if it implies mandatory modelling within AMA as the RTS implies. There are many challenges in collecting the data and modelling it. Institutions should be permitted to decide these matters themselves, subject to internal governance and review by competent authorities as set out in Chapter VII of the draft RTS.

Q4: Do you support the items in the lists of operational risk events in Articles 4, 5 and 6, and the items in the list of operational risk loss in Article 7? Or should more items be included in any of these lists?

> No. The Articles on Legal (4) and Market (5) and Operational Risks (7 & 8) need to be revised. We reject completely the proposals set out in Article 6 with respect to Fraud Risk.

Q5. Do you support that the dependence structure between operational risk events cannot be based on Gaussian or Normal-like distributions, as envisaged in Article 26 (3)? If not, how could it be ensured that correlations and dependencies are well-captured?

> No. We do not support the exclusion of certain distributions and even copulas. We believe that the RTS has the potential to stifle modelling. The draft RTS is far too prescriptive with respect to the identification of probability distributions and the determination of aggregated loss distributions and risk measures.

Q6: Do you support the use of the operational risk measurement system not only for the calculation of the AMA regulatory capital but also for the purposes of internal capital adequacy assessment, as envisaged in Article (42)(d)?

> Yes. However, the EBA need to bear in mind that an institution may have a different confidence interval to 99.90% for internal capital adequacy

Other key matters to bring to the attention of the EBA

1. The EBA should take into account the guidance issued by non-EU competent authorities in order to ensure that EU headquartered institutions that "significant" and "material" operations outside the EU can be accommodated in compliance with the RTS and other jurisdictions with which they also need to comply. This comment also equally applies to EU subsidiaries on non-EU institutions.

2. In order to ensure that there is clarity with respect to the scope of significant operational risk and material operations that must be included in order to achieve AMA compliance we believe that the EBA should have included in this RTS definitions of these terms as required by Article 314. We do agree that the EBA should wait until 31st December 2016 to produce those definitions. This absence of definition poses an unacceptable operational risk to institutions

3. The draft RTS includes many new definitions that are inconsistent with the generally accepted definitions that are set out by the Basel Committee and which institutions have adopted. The RTS should be revised to eliminate these inconsistencies.

Conclusion
In conclusion, in our opinion, the EBA proposals fall short of the standards required and in therefore in their present form, our members do not support them in the current format and content.

If the EBA would like to meet with the BBA and its members to clarify any the comments set in this letter and the supporting comments, we would be happy to do so in order to achieve the publication of the final RTS by 31 December 2014.

Yours faithfully

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DETAILED RESPONSE EBA/CP/2014/08
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- Words in *italics* are extracted from EU CRD Regulation, Directive and or other competent authorities.

- Words in font size 11 Calibri are extracts from the EBF response that we agree with.

Table of contents

Introduction 5
The Basel 2 Framework and EU Directive – Calculating Own Funds Requirement 5
Combined use of different approaches: Significant risk and Material operations 7
Article 20: Joint decisions on prudential requirements 9
Challenges of modelling operational risk across jurisdictions 10
CHAPTER I: GENERAL PROVISIONS 11
CHAPTER II SCOPE OF OPERATIONAL RISK AND OPERATIONAL RISK LOSS 16
CHAPTER III OPERATIONAL RISK MANAGEMENT 32
CHAPTER IV OPERATIONAL RISK MEASUREMENT 34
Section I The four AMA elements 34
Section II AMA modelling assumptions 42
Section III Expected losses and dependence 45
Section IV Insurance and other risk transfer mechanisms 48
Section V Capital Allocation 49
Section VI Parallel Running 51
CHAPTER V DATA QUALITY and IT INFRASTRUCTURE 52
CHAPTER VI USE TEST 54
CHAPTER VII AUDIT AND INTERNAL VALIDATION 55
CHAPTER VIII INAL PROVISIONS 56

Introduction

The Basel 2 Framework and EU Directive – Calculating Own Funds Requirement

There is a good reason for the conceptual framework as set out in the Basel 2 Framework and EU Directive. The current capital framework is clear that the **own funds requirement** (OFR) for each of the risks are calculated independently of each other. This segregation is clearly set out in the Directive and the Regulation that segments that calculation of the own funds requirement into Credit, Counterparty Credit Risk, Equity positions in the banking book under a market based approach, Securitisation, Settlement, Market Risk (includes CVA), and other risks recently added (Central Clearing counterparts and exposures below the thresholds subject to the 25) risk weigh, and then not forgetting Operational Risk. In due course depending upon the outcome of consultation, there may be an OFR with respect to Interest Rate Risk in the Banking Book (IRRBB).

It means that the OFR is the sum of the calculation of each risk (where this is required). It means that changes to the approach to determining the own funds requirement only take place within a risk, such as migration from Credit Risk Standardised to IRB, from Securitisation Standardised to other approaches. It means that there is no cross correlation between risks. Any correlation and or calibration of the OFR exists only within a risk, such as the single risk factor correlation parameters embedded in the IRB approach or the correlations that banks model within market risk portfolios.

If an institution wishes to cross boundaries between risks it is permitted to do so, but only if it adheres to the principles of risk measurement and in compliance with the EU Directive and Regulation,

The underlying concept of the capital framework is that approaches within each risk are comparable and equivalent (subject to various constraints on coverage and various floors and overrides set by the competent authority to compensate for perceptions in lack of equivalence).

With respect to Credit Risk the Standardised approach can be replaced with IRB approaches (subject to approval).

With respect to the measurement of the own funds requirement (OFR) with respect to Operational Risk, the three approaches in increasing levels of complexity (the Basic Indicator Approach (BIA), the Standardised Approach (TSA) and the Advanced Measurement Approach (AMA) are deemed to be super-equivalent. It means that institutions can progress from one approach to the other subject to the EU Regulation, the EBA RTS and approval from competent authorities.

With respect to the AMA approach the expectation is that the TSA acts as a back-stop, a floor, unless an institution can demonstrate otherwise (refer to Regulation Article 313 (3) (a).

It is therefore clear that a boundary exists between these risks that are based upon measurement.

Thus one can conclude that when the Basel 2 framework was drafted and then in turn the EU Directive and Regulations were enshrined in EU law (that in fact replicate the Basel framework) there was a clear desire to maintain the separation between the measurement of these risks as well as with market risk.

We believe that EU Regulation Article 322 (3) (b) that sets out the Quantitative Standards for internal loss data (ILD) was written for the explicit purpose of reaffirming the above approach to the segregation of the calculation of the own funds requirement.

The article is written to ensure that within an institution the modelling of risk is consistent within that bank to take into account its historical data, its business profile and local practise.

This is backed up by Regulation 322 (2) (e) that states

> *an institution's risk measurement system shall be internally consistent and shall avoid the multiple counting of qualitative assessments or risk mitigation techniques recognised in other areas of this Regulation.*

The Directive clearly sets out the responsibility for a competent authority to assess each of these risks separately in Sub-Section 2:

> *Technical criteria concerning the organisation and treatment of risks* starting with Article 76. Treatment of risks: Article 77; Internal Approaches for calculating own funds requirements, Article 78 Supervisory benchmarking of internal approaches for calculating own funds requirements, Article 79 Credit (including Equity, CIU, counterparty risk, settlement risk (each calculated separately), Article 80 Residual risk, Article 81 Concentration risk, Article 82 Securitisation risk, Article 83 Market risk, Article 84 Interest risk arising from non-trading book activities, Article 85 Operational risk, Article 86 Liquidity risk and Article 87 Risk of excessive leverage.

This approach is supported by the Supervisory Review and Evaluation Process (SREP) that looks at the whole risk profile, and other benchmarking and stress-testing.

In conclusion we believe that the requirement of the Directive and Regulation is clear.

It is to ensure that each risk is measured separately, but also consistently within banks and comparable across banks. Very careful thought must be given to cross the boundaries for risk measurement. It is this light that many of the following comments and critique of the draft EBA RTS should read.

Combined use of different approaches: Significant risk and Material operations

The approach to modelling operational risk is made difficult by the fact for institutions spanning multiple countries, across multiple legal jurisdictions and business models.

The consequence is that it is theoretically and practically impossible for all risks in all businesses in all event types (subject to a requirement) to be modelled).

That is why the Basel 2 Framework and the EU Directive and Regulation set out the ability for an institution to combine approaches to determine the measurement of the OFR.

Details are set out in Article 314 of the Regulation.

> *3. For institutions that want to use an Advanced Measurement Approach in combination with either the Basic Indicator Approach or the Standardised Approach competent authorities shall impose the following additional conditions for granting permission:*
>
> *(a) on the date of implementation of an Advanced Measurement Approach, a **significant** part of the institution's operational risks are captured by that Approach;*
>
> *(b) the institution takes a commitment to apply the Advanced Measurement Approach across a **material** part of its operations within a time schedule that was submitted to and approved by its competent authorities.*

This introduces the need to define for each institution significant and material in order to inform and give direction to the institution when developing an AMA model.

However, the EBA has not defined these terms in the draft RTS. The reason is we believe that in the Regulation 314 the EBA is only required to submit draft RTS to define those terms by 31st December 2016.

This causes a risk to all institutions that have already developed and or are considering developing an AMA model.

The risk is that when the EBA sets out in due course its RTS to define significant and material there might be a possibility that those thresholds will be too high such that it will not be possible to obtain approval from a competent authority for the use of an AMA model.

We believe that in order for institutions to assess the scope of the RTS, the EBA should have brought forward the 31st December RTS and thus included in this RTS its proposals for significant and material.

In this regard, we draw the EBA attention to the fact that the Bank of England and PRA has already set out its definitions for these terms that institutions regulated by it are required to comply with in Supervisory Statement SS14/13 Operational risk published in December 2013 that makes specific reference to Regulation Article 314 (3).

The statement is as follows

2 The PRA's expectations in relation to AMA

2.1 A firm may use an AMA in combination with either the BIA or TSA provided it obtains permission from the PRA.

2.2 In granting such permission, the PRA is required by CRR Article 314(3) to impose the following conditions when the AMA is used in combination with BIA or TSA:

- *a) on the date of first implementation of an AMA, a 'significant' part of the institution's operational risk are captured by that Approach; and*

- *b) the institution to commit to apply the AMA across a 'material' part of its operations within a time schedule approved by the PRA.*

2.3 For the purposes of these conditions, the PRA considers that:

- *a 'significant' part of operational risk is approximately 50% or more; and*
- *a 'material' part of its operations is around 85% (or more).*

3 Annual Significant Influence Function (SIF) attestation of Operational Risk Advanced Measurement Approach

3.1 The PRA expects an appropriate individual in a SIF role to provide to the PRA, on an annual basis, written attestation that:

- *a) the firm's AMA (for which it has received a permission) comply with the requirements in Part 3 Title III of the CRR, and any applicable PRA operational risk supervisory statements; and*
- *b) where the firm's AMA has been found not to be compliant, a credible plan for a return to compliance is in place and being completed.*

3.2 Firms should agree with the PRA the appropriate SIF for providing this attestation, noting that the PRA would not expect to agree more than 2 SIFs to cover the firm's operational risk AMA as described in Part 3 Title III of the CRR.

Before the EBA finalises this RTS, we recommend that it publishes an addendum to set out its proposals for the definition of significant and material. We recommend that the EBA should adopt the definitions set out by the Bank of England / PRA.

Article 20: Joint decisions on prudential requirements

We draw the attention of the EBA to this article that states that the competent authorities shall work together, in full consultation. Specifically the extract from para 6 relating to AMA:

Where an EU parent institution and its subsidiaries, the subsidiaries of an EU parent financial holding company or an EU parent mixed financial holding company use an Advanced Measurement Approach referred to in Article 312(2) on a unified basis, the competent authorities shall allow the qualifying criteria set out in Articles 321 and 322 or in to be met by the parent and its subsidiaries considered together, in a way that is consistent with the structure of the group and its risk management systems, processes and methodologies. This point is particularly pertinent to the draft RTS Article 6 – Fraud Risk.

Challenges of modelling operational risk across jurisdictions

The number of institutions that are developing an AMA model and or have developed one is a small group relative to the number of institutions that use the Credit Risk IRB approaches and or the internal model approaches for Market Risk.

Although some institutions will only need to comply with the RTS - because the scope of their operations are at present wholly within the EU - many and most EU institutions span operations that are subject to oversight by competent authorities outside the EU.

In addition the scope covers institutions headquartered in the EU as well as subsidiaries of non-EU headquartered institutions.

The scope is then overlaid with the wide range of legal entity and business operating structures that covers single purpose entity (SPE), multiple purpose entity (MPE) approaches and many combinations of these within one group. And in addition institutions have different structures with respect to where processes and systems are managed, some within a legal entity, some shared, others outsourced to separate ring-fenced operational subsidiaries and some outsourced to third parties.

The different guidance that has in the past been given to institutions in different parts of the world, either informally in expressing a preference for one kind of AMA model approach and or formally in guidance has been a source of concern and at times confusion.

Thus it well understood that EU institutions need to take into account the guidance and rules from other competent authorities such as the US regulators when developing AMA models, in order to ensure that the group approach is acceptable to them e.g. the US authorities that mandates that any AMA model calculates the OFR for the Operational risk on a standalone ring-fenced basis for the institution's US operations where these are measured within a US holding company.

Where the US operations of a EU institution are significant and material in order to achieve compliance with Article 314 (3) - that as set out above the Bank of England regards as 50% and 85% respectively - generally it does not make sense to develop different AMA models of use in the USA compliant with US regulators and a different model for use in the EU and or at a consolidated level. Such an approach fails the use test as proposed in the draft RTS chapter VI – Use Test.

We therefore are concerned that the draft RTS has not taken the opportunity to review the guidance and rules on AMA models that have been published by competent authorities outside the EU in order to ensure that an AMA model can be developed for an EU institution in compliance not only with the RTS but also in compliance with the principal regulations set out by other competent authorities,

We therefore believe that many of the RTS articles could be improved by utilising the text published by other competent authorities most notably those published by the Basel Committee [2] , the US Federal Reserve [3] and the guidance and rules published by competent authorities including the Bank of England / PRA as set out above.

[2] Dec 2013: Progress in adopting the principles for effective risk data aggregation and risk reporting
Jan 2013: Principles for effective risk data aggregation and risk reporting
Jun 2011: Operational Risk - Supervisory Guidelines for the Advanced Measurement Approaches
Jun 2011: Principles for the Sound Management of Operational Risk - final document
Oct 2010: Recognising the risk-mitigating impact of insurance in operational risk modelling
Nov2007: Principles for home-host supervisory cooperation and allocation mechanisms in the context of Advanced Measurement Approaches (AMA)

CHAPTER I: GENERAL PROVISIONS

Article 1 Definition and Scope of Operational Risk:

In the background and rationale the EBA has stated that:

> "*the Regulation does not provide any further indication of the 'scope of operational risk' and the 'scope of operational risk loss', leaving the definitions open to different interpretations and allowing institutions to choose how they are implemented".*

We disagree with the EBA.

Institutions are clear with respect to the scope as set out in Article 4(52) that operational risk includes legal risk and as per the Directive Article 85 it defines operational risk to include model risk. [4]

Article 3 (52) of the Regulation: *'operational risk' means the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events, and includes legal risk;*

The definition is consistent with the Basel 2 Framework

> *V. Operational Risk: A. Definition of operational risk*
>
> *644. Operational risk is defined as the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. This definition includes legal risk, but excludes strategic and reputational risk.*

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[3] June 3, 2011: INTERAGENCY GUIDANCE ON THE ADVANCED MEASUREMENT APPROACHES FOR OPERATIONAL RISK http://www.federalreserve.gov/bankinforeg/srletters/sr1108a1.pdf

June 30, 2014: Supervisory Guidance for Data, Modeling, and Model Risk Management Under the Operational Risk Advanced Measurement Approaches http://www.federalreserve.gov/bankinforeg/basel/files/bcc1401.pdf

April 4, 2011: SUPERVISORY GUIDANCE ON MODEL RISK MANAGEMENT http://www.occ.treas.gov/news-issuances/bulletins/2011/bulletin-2011-12a.pdf

[4] 1. Competent authorities shall ensure that institutions implement policies and processes to evaluate and manage the exposure to operational risk, including model risk, and to cover low-frequency high-severity events. Institutions shall articulate what constitutes operational risk for the purposes of those policies and procedures.

Para 2.

Model Risk

Model risk is referred to directly in Article 1.2 and indirectly, in Article 5 paragraphs 2, 3 and 5, however, there is no supporting definition in Article 2.

The lack of a definition for Model Risk in may result in inconsistency of interpretation and data collection.

Institutions comprehend that model risk is as set out in Article 4 of the Regulations
12)

> *"model risk" means model risk as defined in point (11) of Article 3(1) of Directive 2013/36/EU*; namely that *model risk' means the potential loss an institution may incur, as a consequence of decisions that could be principally based on the output of internal models, due to errors in the development, implementation or use of such models*;

For the avoidance of doubt the definition of model risk should be included in the list of definitions set out in Article 2.

Furthermore, we draw the attention of the EBA to EBA/CP/ 2014/14 on the SREP process mentions a definition and suggest a split. We consider first, this rule should not be in document on SREP process and second that the proposal included in the EBA/CP/ 2014/14 should be improved.

Exclusion of other kinds of risk

We note that the text includes the phrase "*with the exclusion of other kinds of risk*".
This is unnecessary and does not add any value to the definition of operational risk.

The Directive and Regulation is clear as to what is in scope for operational risk.

(10) 'information and communication technology risk'

We note that in Article 1 (2) the EBA has decided to expand that scope as follows:

> *The competent authority shall verify that an institution has included legal risk, information and communication technology risks, as well as model risk, within the scope of operational risk with the exclusion of other kinds of risk.*

There is no need to single out "*information and communication technology risks*" in the scope as defined in Article 2

> *(10) 'information and communication technology risk' means the risk of losses due to the inappropriateness or failure of the hardware and software of technical infrastructures, including risks compromising their availability, integrity, accessibility and the security of data.*

The all-embracing term "*risk of loss resulting from inadequate or failed internal processes, and systems"* embraces all of the EBA definition of "*information and communication technology risks*". The definition should be deleted.

These and other risks (not specifically mentioned) form part of the scope of operational risk.

Article 2: Definitions

Legal Risk

In paragraph (12):

> *'legal risk' means the risk of being sued or being the subject of a claim or proceedings due to non-compliance with legal or statutory responsibilities and/or to inaccurately drafted contracts. It also includes the exposure to newly enacted laws as well as to changes in interpretations of existing laws;*

We do not support the definition.

We believe that the definition of "*being sued or being the subject of a claim*" does not constitute a necessary condition to consider an action accountable as legal risk.

The part of the definition that says "*inaccurately drafted contracts,*" covers only partly legal risk.

The EBA has chosen to set out in Article 4 further details supplementing the definition set out in Article 2 (12). Our opinion is as follows:

The definition is inconsistent with the definition set of by the Basel Committee that institutions have endorsed namely

> *"the possibility of being sanctioned, fined or forced to pay punitive damages resulting from supervisory actions or private agreements between the parties*".

The EBA should changes its definition set out in Article 2 (12) to be compliant with internationally accepted standards that embrace the definitions that banks already set out in their annual report and accounts. [5]

In summary, the EBA standards are too detailed and too prescriptive. More is less and thus the article should be reduced in scope and focus on the definition of legal risk.

(1) AMA institution

> *means an institution being permitted to use or already using an AMA;*

For the avoidance of doubt, we believe that the definition should be change to as follows

> *means an institution that is permitted to use or already using an AMA in compliance with Title III of the regulation "Own funds requirements for Operational Risk set out in Articles 312 – 324*

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[5] The following is an extract from a member's 2013 Annual Report & Accounts that sets out that legal risk falls within the definition of operational risk and includes:

- contractual risk, which is the risk that the rights and/or obligations of a company within a contractual relationship are defective;
- dispute risk, which is made up of the risks that a company is subject to when it is involved in or managing a potential or actual dispute;
- legislative risk, which is the risk that a n company fails to adhere to the laws of the jurisdictions in which it operates; and
- non-contractual rights risk, which is the risk that a company's assets are not properly owned or are infringed by others, or a company infringes another party's rights.

(9) 'gross loss'

> *means a loss stemming from an operational risk event or event type - as referred to in Article 322(3)(b) of Regulation (EU) No 575/2013 - before recoveries of any type;*

The cross reference should be to *Article 322(3)(**d**)* not (*b) as stated.*

Other losses

We have many concerns with respect to the definitions of (13) near misses, (15) operational risk gains, (19) opportunity costs / lost revenues, (20) pending losses and (27) timing losses; and their use in AMA modelling.

Further comment is set out in our response to RTS Article 7.

(13) Near Misses

There is no need to give examples in definitions
> *such as an IT disruption in the trading room just outside trading hours*

This should be deleted

(21) Recovery

The definition only refers to what is commonly known as "*indirect recovery*".

We propose to also give a definition of "*direct recoveries*".

Alternatively the definition could be completed "… *received from the first party or from a third party, such as insurers or other parties*."

(27) Timing losses

We note that in the EBA document it is specified that:

Article 7 - , "*timing losses that span more than one accounting year and give rise to legal risks" should be included in the operational risk losses*;

Article 8.3 - "*In case of timing losses, the loss amount to be recorded comprises all the expenses incurred as a result of the operational risk event, including the correction of the financial statement, when it involves the direct relation with third parties (such as customers or authorities) or employees of the institution, and excluding the correction of the financial statement in all other cases*".

These definitions are different to that set out article 2 (27) is *"timing losses means negative economic impacts booked in an accounting period due to operational risk events impacting the cash flows or financial statements of previous accounting periods. Timing impacts typically relate to the occurrence of operational risk events that result in the temporary distortion of an institution's financial accounts (such as revenue overstatement, accounting errors and mark-to-market errors)"*.

According to the definition "*result in the temporary distortion of an institution's financial accounts", they usually do not generate an effective loss to the institution, even if they span more than one accounting yea*r.

Hence it is not clear why – according to article 7 (1) d - the timing loss itself shall be included in the scope of AMA calculation.

However in case the timing loss causes legal risk, this legal risk should be considered for AMA calculation. This treatment is consistent to the example iii) given in the Explanatory Box on page 28.

We propose to amend the text to "*legal risks arising from timing losses that span more than one accounting year*."

We support the definition under Article 7 (1f) of timing losses however tax related payments should be explicitly excluded since these are not related to operational risk.

CHAPTER II SCOPE OF OPERATIONAL RISK AND OPERATIONAL RISK LOSS

General principles: Article 3

Article		
4.	Legal Risk	Too detailed, too prescriptive. Definition needs change
5.	Market Risk	Inappropriate definition and lack of clarity
6.	Credit Fraud Risk	We reject completely the EBA proposals.
7	Operational Risk Loss	needs to be moved into Chapter IV – Measurement
8	Recorded Loss	needs to be moved into Chapter IV – Measurement

The following sections set out of opinion on this article and the following articles

Overarching comments

The RTS is deficient because it does not clearly differentiate between the management of and measurement of operational risk.

It is inappropriate to include in this one chapter these different aspects and also overlapping risks of Legal, Market and Fraud risk together with operational risk losses and recording of losses.

The de facto purpose of this chapter is an attempt to set out the boundary between and overlap between the scope of what should be included in operational risk measurement and what should be excluded.

By only including Credit and Market risks, it is unclear if the EBA considers if any boundaries exist between other risks, such Equity, Securitisation, CIUs, Settlement risk, Residual risk etc.,

Furthermore, by putting this chapter up front it distorts the overall tone and focus of the RTS.

Matters relating to clarification regarding

- **management** should be included in chapter III (Operational Risk **Management**)
- **measurement** should be included in chapter IV (Operational Risk **Measurement**)

In order to explain our comments, we have changed the sequence of our response and comments on the draft RTS articles set out in this chapter

In summary:

- We believe that the EBA has misinterpreted the Regulation with respect to the requirement to include in an AMA model all of the event types listed in table 3 in Article 317.
- Therefore, we do not agree with the proposals set out in Recital (8) and Article 6 with respect to Fraud events in the Credit Area.
- The article on Market Risk needs to be changed to align it with the scope covered under the OFR for that risk.

Article 4: Operational Risk Events related to Legal Risk

Please refer to the previous comments set out above with respect to the definition:

Provisions of Article 4 (2) (b), 4(3) (a) stipulate that events related to breaches of ethical conduct rules have to be included in the scope of operational risk.

From our point of view, this provision leaves wide room for interpretation because the notion of ethical conduct may differ considerably over time, between institutions, jurisdictions or individuals.

We propose to exclude the term from the provisions listed above as well as from the provisions of Article 4(5) especially considering the fact that many institutions has in place a Code of Conduct or comparable internal rules.

Taking into consideration that the breach of internal rules also has to be included in the scope of operational risk, the provision would further sufficiently cover the envisaged scope whilst limiting the scope to the events related to written rules which are communicated to the appropriate employee level in a duly manner.

It is unclear why breaching an institution's internal rules is considered as legal risk as long as it does not breach legislative or regulatory rules at the same time.

Further uncertainty is created about the exact nature of the internal rules (whether principles, policies, standards or procedures).

For clarity, we propose to delete some text so that the paragraph becomes "*events related to decisions made by an internal competent decision-maker but breaching legislative or regulatory rules*".

To provide consistency paragraphs 4 and 5 (a) should be amended the same way.

Specific Comments

These are consistent with those set out in the EBF response to Q4.

Paragraph 2

On the list of operational risk events related to legal risk, we think internal rules and/or ethical conduct that do not imply a violation of external rules should not account as legal risk.

Paragraph 3
point (a)

We sustain that internal rules and/or ethical conduct should not be considered as legal risk.

point (b):

"expenses stemming from legal disputes or from interpretations of legislative or regulatory rules which prove to be against industry practice," we see these expenses as legal risk if only prevails in them.

point (c),

When voluntary compensation to customers is done, it should be only to the extent that it was used to avoid a legal risk, in line with Article 4 paragraph 2 point (a). Also concerning point (c), the identification of the 'same event' is not straightforward in practice given that the marketing of a product will depend on the personal and financial circumstances of the customer, for instance.

General

We think the wording of Article 4 is quite confusing and should therefore be clarified. In particular, paragraph 3 should be more concrete and specific. It is not clear the distinction between paragraph 2 and 3 (in Article 4), and we think it might be better to integrate them into a single paragraph.

It is unclear whether the specific cases cited in paragraph 3 materialize in the events referred in paragraph 2 or, conversely, are part of the whole or in addition to the events listed in paragraph 2. The scope of 'regulatory rules' should be clarified, even if it is a commonly accepted term to avoid interpretative doubts.

We would like to know what consideration / implication out-of-court settlements as an operation risk event. Among these, are there cases in which financial institutions should consider that there is operational risk?

Paragraph 5:

Examples could include various forms of business or strategic risk. Given the exclusions from the definitions it would be helpful if the same terminology could be used here.

From the perspective of consistency with the definition of operational risk, it would be useful to explicitly mention Strategic and Reputational Risks as being excluded.

Article 5 Operational Risk events related to Market Risk

The EBA has considered it necessary to define the scope of Market Risk

> *1. Operational risk events occurring in market-related activities shall be classified as boundary events between operational risk and market risk. These events, and the related losses, shall be included within the scope of operational risk for the purpose of calculating the AMA regulatory capital.*

We do not support this definition. The use of the term '*market-related'* is not used anywhere in the Directive or Regulation.

There is a wide variety of possible operational risk events in market-related activities which do not generate market risk.

The title of Article 5 "Operational risk events related to market risk" is inappropriate given that the content of Article 5 mainly refers to transaction-related life cycle events in trading activities. Such events are entirely within the scope of operational risk and AMA measurement and their designation as 'boundary' events is misleading

In our opinion it is not necessary to introduce a second flag (besides the market risk flag) for events in market-related activities as this information is already given by assigning business lines to operational risk events.

Institutions are clear that the scope covers the risks that fall with the definition of Market Risk set out it in the Directive Article 83 and the approaches to the calculation of the own funds requirement for market risk set out in Title IV of the Regulation commencing with Article 325.

The paragraph is superfluous and should be deleted.

However, for the avoidance of doubt, if the EBA may wishes to provide clarification then it might be advisable to clarify that the scope:

- Includes losses that relate to the Directive Article 83 Market Risk, Article 84, Interest risk arising from non-trading book activities and Article 86 Liquidity risk.
- Excludes losses that are modelled and or explicitly included in other risks.

We do not understand to which type of "errors in classification due to software" Art 3 (b) intends to cover and to which extent they are to be considered as operational risk.

Unauthorised market positions taken in excess of limits

We agree that it is prudent to include in the operational risk loss database the profits and losses in excess of authorised limits as events. However, one must take care when mandating the inclusion of such losses in the AMA model in all cases. This is inappropriate.

We have reviewed point 3 (g) "*unauthorised market positions taken in excess of limits*".

We agree with the inclusion of the word *unauthorised* to frame this loss category.

There will be occasions when due to changes in the market the position may move to be in excess of a limit and or where a trader actually takes a position in excess of limit that is a) either unavoidable or unintentional or b) is intentional to protect hedge risk and thus reduce losses.

The EBA will be aware that market risk models are designed to operate within the boundaries within which they are developed and used. That is why for example such models are subjected to stress testing, stress VaR and expected shortfall. It is though quite possible that market movements can occur that fall outside the scope and the back-testing limits, thus resulting in excess losses (or windfall profits). These in turn might breach and usually do breach limits. Such losses fall within the scope of the capital requirements within TITLE IV of the Regulation covering Market Risk Articles 325 – 377.

It is therefore important that the EBA recognises that where the capital requirement is covered within those articles, then that overrides any requirement to include losses in the AMA model.

From this we conclude that if the internal review and governance process approves the excess position then it is no longer considered unauthorised.

Hence the reason for inclusion of unauthorised is clear in that is only unauthorised positions are included. These may result in excess profits and or excess losses. In the event that an excess profit is derived from an unauthorised position, we would recommend that the profit is excluded from any modelling.

Exclusions

We agree with the exclusions as set out in 5 a) and b). The reason being that these losses will be captured within in the scope of operational as set out in RTS Article 7.

Article 6: Fraud events in the credit area

In fact the above EU Regulation 322 (3) (b): (consistent with the Basel 2 Framework) continues on to say that there is no requirement to model operational risk losses related to credit risk, providing that the risk is modelled in the credit risk approach.

> *An institution shall record the operational risk losses that are related to credit risk and that the institution has historically included in the internal credit risk databases in the operational risk databases and shall identify them separately. Such losses shall not be subject to the operational risk charge, provided that the institution is required to continue to treat them as credit risk for the purposes of calculating own funds requirements.*
>
> *An institution shall include operational risk losses that are related to market risks in the scope of the own funds requirement for operational risk;*

However, what is clear from the proposal set out in draft RTS Article 6 is that the EBA has interpreted the Regulation as mandating that all events listed in the Regulation Article 317 Table 3 must be included in the scope of modelling for AMA purposes.

In part the EBA justifies its approach by setting out its rationale in a lengthy explanatory box.

A choice of approach is permitted consistent with the Regulation

The EBA notes that for some institutions that have adopted an AMA model they have changed the modelling of credit risk and operational risk to include fraud risk in the latter. In fact for an institution that is operating within the EU and has over 85% of its credit risk modelled according to the IRB approach and then has over 85% of its operational risk modelled in accordance with AMA, it makes perfect sense and it is logical that such an institution would ensure that the modelling of fraud risk would be consistent within each risk and across risks to ensure that it does not double count the risk.

Therefore, we have no objection to an institution choosing this option in compliance with the Regulation.

What we object to is the EBA deciding that institutions should no longer have any choice. We therefore disagree completely with EBA proposals.

Also, we believe that the purpose of the explanatory boxes should not to justify the EBA's points of view. This should have been set out background and rationale.

Modelling a risk in a consistent manner throughout an institution

There are many institutions that do not fall into the neat bucket of Credit IRB Risk and OPR AMA model risk in excess of 85% covering more than 50% of the operations.

So, it is inappropriate for the EBA to mandate the modelling of fraud risk always within the AMA model, because for many institutions it will not be possible to exclude the risk from the credit risk, because in many cases the own funds requirement for credit risk will calculated on the Standardised Approach.

In such as case the inclusion of fraud risk in the AMA model will result in a duplication of the capital requirement that is already included in the Credit Risk Standardised Approach. In such a circumstance the institution will not be able to reduce the minimum capital requirement for Credit risk.

This in turn might lead to a situation in which an institution that is contemplating developing an AMA model might choose not to do so, if the result might be a misstatement of and double counting of the impact of fraud within the total loss over the forthcoming year. Fundamentally, this draft RTS Article sets out the EBA draft proposal to mandate and thus determine the boundary between the Interaction of the modelling of Credit and Operational Risk. It is our opinion that the Regulation is very clear and accords with the current practise of institutions in the EU. It provides institutions with a choice that ensures consistency with risk measurement practises.

Institutions are required to separately record and identify these operational credit risk events in the loss data. And it should be clear that the recording also covers events relating to Securitisation and all other risks that might exhibit internal and external fraud that have a 'credit risk' similarity.

But where an institution includes these losses in its modelling of credit risk (IRB and other modelled approaches), it should **not** include the losses in operational risk AMA modelling.

The approach that institutions have adopted not only takes into account the nature of the loss, including - but not limited to - first and third party fraud, but also is dependent upon the credit risk portfolio.

Yet, the EBA has decided that the flexibility accorded in the Regulation is unacceptable and that uniformity of approach should be established. The EBA's rationale is set out in Recital 8 and expanded in Article 6. The EBA has decided to require all first and third-party fraud to be modelled as an operational risk.

We do not agree with the EBA for the following reasons

- It contradicts the Regulations that require an institution to manage risk that is internally consistent within a risk class (Directive Article 78 – 87)

- To mandate a uniform approach would result in incomparability across banks and an irreconcilable inconsistency within banks because institutions using the Standardised OPR Approach and or the Basic Indicator Approach will be excluding these losses.

- It makes the parallel running impossible to validate because the non-AMA approaches cannot be compared to the AMA approach

- On the basis that the inclusion of these losses in the calculation of OFR for Operational Risk is likely to increase the calculation compared to the Standardised / BIA, it would make it almost impossible for bank to revert back from AMA to the less sophisticated approaches because it would be in contravention of Regulation Article 313 (3) [6]

[6] 3. An institution may only revert to the use of a less sophisticated approach for operational risk where **both** the following conditions are met:
(a) the institution has demonstrated to the satisfaction of the competent authority that the use of a less sophisticated approach is not proposed in order to reduce the operational risk related own funds requirements of the institution, is necessary on the basis of nature and complexity of the institution and would not have a material adverse impact on the solvency of the institution or its ability to manage operational risk effectively;
(b) the institution has received the prior permission of the competent authority.

- It also introduces an irreconcilable difference to model operational risk when an institution is permitted to adopt combined use of different operational risk measurement approaches in accordance with Regulation Article 314.

- The EBA has focussed only on Fraud risk in the Credit Risk area. The reality is that fraud can take place in other areas of risk that will not be included.

- For institutions with operations spanning both EU and non-EU countries, the latter will be subjected to the approach set out by the Basel Committee that is embraced by Regulation that separates the measurement of each risk. Implementing the proposed EBA RTS results in inconsistency with the guidance from the Basel Committee and other non-EU jurisdictions. The consequence might well be that an institution would need to have two AMA models and two different approaches to consolidation to take into account the different standards.

Lack of harmonisation with Basel Committee and other non-EU competent authorities

The EU is home to many internationally active institutions that have operations outside the EU who have and or are developing AMA models.

The EU does not take into this matter. An enforcement of the RTS without discretion from the EU home competent authority could result in the withdrawal of permission for use of the AMA model because it does not comply with the policies set out elsewhere.

The RTS should recognise the flexibility accorded within the regulation 322 (3) (b):

Inconsistency with other RTS consultation paper

We draw the EBA attention to 26 June 2014 EBA/CP/2014/10 Consultation Paper: Draft regulatory technical standards on the sequential implementation of the IRB Approach and permanent partial use under the Standardised Approach under Articles 148(6), 150(3) and 152(5) of Regulation (EU) No 575/2013 (Capital Requirements Regulation– CRR)

This proposes to place an onus upon the competent authority to ensure that when an institution progresses from the Credit Risk Standardised Approach to the IRB approach that it does not result in an underestimation of the own funds requirement, i.e. the capital ratio.

The proposals by the EBA to mandate including fraud risk within AMA modelling causes unnecessary challenges in compliance with whatever finalised RTS is published with respect to the permanent partial use of IRB.

Concerns with explicitly modelling all Fraud Risk within AMA

The EBA has chosen to group all types of fraud risk (first and third party fraud) within the scope of AMA modelling

Thus may be a logical reason for including third-party fraud within the modelling of AMA risk. The most obvious example is credit card fraud in which any loss suffered by the client is reimbursed to the client

Whereas when modelling Credit Risk for Corporate Risk such events are rare. The more normal type of fraud is first-party fraud that causes the default of the obligor and thus it would be appropriate to include such events in modelling credit risk because one of the factors would be an assessment of the trust in the management team

We agree with the following set out in the EBF response.

The operational risk related to credit risk is an intricate notion that requests deep analysis on a case-by-case basis. In order to guarantee consistent practices for all cases, and to avoid unsystematic transfer of these losses under AMA, the principles of the Article 6 would need therefore to be clarified.

Furthermore, there is a risk to double count the same risk in both credit and operational risk capitals, and that credit risk capital requirement still contains "hidden / never identified credit fraud". To avoid double counting, institutions should be authorised to extract from their database such fraud events from the credit risk.

We therefore look for a clarification on the credit risk methodological assessment side in order to preserve the intrinsic consistency of the CRD standards. However, this would involve considerable implementation effort for both the institutions themselves and data consortia may they concern operational risk or credit risk. The question arises as to how the current rating procedures could remain in existence if some banks had to consider losses from the credit risk and others not.

The change in event categorisation must be supported by Credit Risk Management functions and regulators. For Credit Risk Management the implications range from data collection, to data history in risk analysis, to the amount of capital required for Credit Risk.

The Credit Risk consultation paper will necessarily need to be consistent with the implications and effects in Article 6. Operational Risk Management functions cannot be expected to implement data collection related to the credit area without the active support of regulators specialising in the credit area.

Fraudulently incurred credit events are an integral part of the parameterization of credit risk models. As credit risk models are exposure based they provide forward looking risk assessment and risk awareness directly linked to the current business decisions. The removal of operational risk losses from credit risk models would reduce the credit risk provisions instantly without the connection to improvements of the credit processes.

Furthermore in most institutions the fraud prevention methodology is closely linked to the credit rating development. AMA models are based on historical losses, not on current exposures. As fraudulently incurred credit defaults are way more exposure based than other operational risk events, the pooling of this data for operational risk modelling is extremely challenging. The precise allocation of fraudulently incurred credit losses is beyond current standards in operational risk modelling. Therefore, we strongly do not support the inclusion of these events for AMA capital calculation as it does not enhance the overall evaluation and management of these risks. We are convinced that credit risk models are the best solution for the modelling of operational risk losses related to credit risk due to their exposure based nature.

We also estimate the costs for implementation extremely high and not appropriate compared to the additional information gained for OpRisk management.

Thresholds for collection

For institutions that do choose to include these losses in AMA we therefore propose a higher collection threshold.

The analysis whether fraud has been committed can take several months. Thus losses would have to be moved from credit risk models to AMA models once the fraud has been proven. This needlessly causes instability both for credit risk and for AMA models.
It may therefore introduce several sources of uneven playing field. Indeed, it introduces discrepancies between IRBA/AMA banks compared to IRBA only entities. Furthermore, it hampers a fair comparability across institutions belonging to different jurisdictions. In addition to the complexity of implementation in operational and credit Risks IT systems, it would induce uneven playing field if only applicable to EBA regulated perimeter without any convergence with BCBS standards.

We consider also the amount of the loss to be recorded to be problematic (Article 8(1d)). It should be mentioned that loss mitigations could be included (realization of collateral for instance).The outstanding amount of credit at the time of discovery of the fraud does not necessarily correspond to the amount of the write-off. Further repayments of principal and proceeds from realisation of collateral should be eligible as loss mitigation. In particular, the amount of the credit guarantees collected and the associated amount of the unsecured portion played a key role in the decision to grant credit. Accordingly, it should also be possible to take into consideration the eligible value of the collateral in the assessment of the operational risk.

We suggest, instead of the present proposal, allowing assessment of the loss to be undertaken on the basis of the amount of the reserve.

Implementation date

Furthermore, we consider that the implementation deadline stipulated in Article 47 is far too short.

A two-year transitional period would be insufficient to meet the challenges of double counting appropriately. In addition, a change in definition would interrupt the data history. In order to ensure the reliability of the data, a corresponding data stock including consideration of the credit risk would have to be built up. In any case, this requires more time than the 2-year period envisaged. Taking into consideration the technical implementation work, an appropriate transitional period should be about 5 years.

Under the assumption that our remarks are considered and implemented we support the contemplated phase-in approach given a new timeline of 5 years.

Conclusion

In conclusion, although in theory the EBA proposals with respect to Credit Risk might have merit, from a practical perspective they are impractical and inconsistent with the EU Regulations.

We therefore do not agree with the CHAPTER VIII FINAL PROVISIONS Article 47

- Article 6(1) shall apply after two years from the entry into force of this Regulation.
- Article 6(3) shall apply after one year from the entry into force of this Regulation.

Article 7: Operational Risk Losses

This Article should be moved into Chapter IV – Measurement.

The RTS sets out is requirements for a prescriptive list of what should be included in an operational loss data base.

We welcome the EBA giving a list. But the list needs to be differentiated between data items that must be in the data base and the list of data items that should merely be for consideration.

Employee related costs

For example to mandate that the cost of overtime and or bonuses are recorded and not the actual day to day costs of employees who are responsible for investigation of events and resolution of losses is inconsistent.

For example, during the past few years and for the foreseeable future many institutions have significant numbers of employees involved in rectifying the losses including restitution to clients for prior failings as well as costs to rectify prior regulatory failings for which the institution has incurred fines and or a requirement to change its business and or processes and or systems.

The EBA is clear that the following items *shall be excluded from the scope of operational risk loss*

a) *costs of general maintenance contracts on property, plant or equipment;*
b) *internal or external expenditures to enhance the business after the occurrence of an operational risk event such as upgrades, improvements, risk assessment initiatives and enhancements;*
c) *insurance premiums.*

We therefore conclude from this that on-going costs to resolve prior operational risk failings should be excluded in the modelling of future losses. It is therefore logical to extend this scope to overtime and bonuses etc.

We therefore do not agree including modelling of overtimes and bonuses in the AMA model

It is important to remember that the on-going costs such as these and the other costs that the EBA has specifically set out that can be excluded in paragraph 3 a) and b) are expenses that flow through the income statement and thus an institution is already setting aside 100% of tax-adjusted total of these expenses.

We suggest that it would be wise for the EBA to set out these matters to put forward a draft paragraph that states that the on-going costs of employees (and related employee costs either internal and or paid externally) are excluded from AMA modelling because they are already provided for in the capital framework through the income statement.

However, an institution should consider incremental costs that could be incurred in the next year in accordance with the forward looking aspects of modelling

It is important to institutions that the RTS does not allow any opportunity for individual competent authorities to establish supplementary and or contradictory and conflicting standards.

Threshold

An institution is permitted to refrain from collecting internal data for individual operational losses below established threshold amounts if the bank can demonstrate to the satisfaction of its competent authority that the thresholds are reasonable, do not exclude important internal operational loss event data, and permit the bank to capture substantially all the value of the bank's operational losses.

We note that the RTS is silent on this matter that can have both an impact upon measurement and loss collection.

We encourage rules to be established where the value is denominated in EUR 10,000, USD 10,000 and GBP 5,000 based upon the current practise of institutions operating in the EU.

Provisions or reserves accounted for in the P&L against potential operational losses

We agree that these should be included in the AMA model.

Article 7(1):

There are difficulties of performing a fair estimation of cost of repair or replacement mentioned in Article 7 (1b2).

Indeed, after a risk event, one may choose to enhance the former situation rather than just to restore it. It is then quite unclear to assess which part of the cost should be considered to include in OR database.

When deciding to take all the components of the enhancement, it would unduly burden the entities promoting enhancement rather than pure restoration. We propose the text should make it clear that it should be assessed on a best effort basis

Furthermore, the provisions of the article 7 (1d) leave a room for interpretation that may lead to very heterogeneous practices across institutions. We would prefer a simpler rule such as pending losses over 2 years or over a certain amount that could be 1 % of the NBI of a given entity.

Standards with respect to recording and reporting losses

Article 7 (2) it should be acknowledged that higher thresholds can be applied for the collection of these events as only events with a high impact can be identified with reasonable effort and only those events are relevant for OpRisk management decisions.

The EBA has introduced a range of terminology to define other types of losses that the EBA requires institutions to record in institutions.

The list includes cost of repair, pending losses, uncollected revenues, timing losses that span more than one accounting year and give rise to legal risks, near-misses, operational risk gains and opportunity costs/lost revenues.

An important tenet of an AMA framework is that there is line of sight and reconciliation of the operational risk loss database and the financial statements (the income, expense, profit and loss statement).

The EBA does not seem to set out the overarching requirement of a governance framework that is required to be established between the finance and operational risk management functions that ensures that this process is reconciled.

The EBA should revise this Article to set out a clearer segregation of accounting entries that actually flow through the profit and loss statement that are identifiable as operational risk events as distinct to actions that do not flow through the accounting entries.

It is important to remember that the primary objective is estimate the actual loss from operational losses that might flow through the income statement. The objective is not to estimate hypothetical losses.

The standard should be that the list is merely a list of events that an institution should consider in its AMA model. It should have a governance process to assess the events and establish consistent approaches throughout the institution and review on a regular basis.

It should be for each institution to determine the extent to which these “losses” or “pseudo-losses” are included or excluded taking into account materiality and other factors.

Definition 20: Pending Losses

The concern appears to relate to perceived or actual misuse of suspense accounts and pending losses in relation to operational risk losses. These items are probably pending losses while the more certainty is achieved over the loss estimate, for example is it £10 Million or £10,000.

The finance / accounting / control function operates pending losses and suspense accounts within the formal accounting standards.

For clarity the second portion of the definition should be deleted

> *The impact of some events, such as legal events, internal frauds, damage to physical assets, may be known and clearly identifiable before these events are recognized through the establishment of a reserve;*

Uncollected revenues

For uncollected revenues it is impossible to ensure completeness.

The Policy statement with penalties for non-compliance and/or high thresholds must be allowed to make this practical.

It is recognised and appreciated that uncollected revenues are an economic loss to the firm. However, capturing these losses is difficult. One potential data source, the General Ledger, is used to tracking things that did happen rather than things that did not happen. Firms should be able to agree a threshold, with their home regulator, for capturing uncollected revenues. For uncollected revenues it is impossible to ensure completeness. Policy statement with penalties for non-compliance and/or high thresholds must be allowed to make this practical.

Timing Losses
Please refer to our comments on the definition

We support the definition under Article 7 (1f) of timing losses however tax related payments should be explicitly excluded since these are not related to operational risk.

Near-misses and operational risk gains

The implementation of this requirement would pose a large number of challenges for the institutions. We point out that in contrast to genuine losses, near-misses leave no “traces” behind in accounts and therefore the exhaustiveness of the recording of the relative operational risk events cannot be guaranteed. Then the bias induced in the loss collection doesn’t allow a proper statistical use of these data.

Opportunity costs / lost revenues

They are in fact already covered by article 7 (1 d & e) (pending losses and lost revenues).

For all these items, it is doubtful to include them in a data collection exercise given the fact that, as mentioned above and indicated in Article 2 itself, they do not lead to any charge in the P&L,

Article 8: Recording Operational Risk Losses

This Article should be moved into Chapter IV – Measurement.

No matter which approach an institution utilises to calculate its own funds requirement for operational risk, ever since the Basel 2 Framework was published in 2004, most institutions have established operational risk loss databases to record losses in accordance with the granularity set out in Annex 8 (Mapping of Business Lines) and Annex 9 (Detailed Loss Event Type Classification).

Regulation Article 317 Table 3 (that is consistent with the Basel framework) defines the Event -Type Categories for which an institution must record losses. Included in the list of event types are Internal and External fraud.

- *Internal fraud: Losses due to acts of a type intended to defraud, misappropriate property or circumvent regulations, the law or company policy, excluding diversity/discrimination events, which involves at least one internal party*

- *External fraud; Losses due to acts of a type intended to defraud, misappropriate property or circumvent the law, by a third party*

Paragraph 673 in the Basel 2 framework sets out the guidance with respect to the internal loss collection process that must be in place as a pre-requisite for obtaining AMA approval

> *To qualify for regulatory capital purposes, an institution's internal loss collection processes must meet the following standards*:

The following paragraph in the Basel 2 Framework is the same as the first part as set out in EU Regulation 322 (3) (b):

> *an institution shall be able to map their historical internal loss data into the business lines defined in Article 317 and into the event types defined in Article 324, and to provide these data to competent authorities upon request.*
>
> *In exceptional circumstances, an institution may allocate loss events which affect the entire institution to an additional business line "corporate items".*
>
> *An institution shall have in place documented, objective criteria for allocating losses to the specified business lines and event types.*

The draft RTS Article 8 would therefore benefit by including this requirement to align it with the Regulation and Basel 2 Framework. The Regulation is clear. The losses must be recorded. However, most importantly it does not state that all these event type must be included in the AMA model. It allows an institution discretion to choose its approach.

Specific comments

(1a), for clarity, a change should be made, in particular inserting "*external*". It is proposed that this paragraph should be: "*all the external expenses incurred as a result of the operational risk event*…".

The treatment described in Article 8 (1b) partially differs from former regulatory position, to ensure consistency throughout the historical data, we advocate for keeping things unchanged from previous standards. These matters are already covered in RTS Article 5 and thus should be deleted.

(3), there is uncertainty as to whether the expenses are internal and external or just external. Article 7. 1b1 refers to external expenses and 1b2 cost of repair.

On article 8 (1d), several questions are put forward to the EBA:

- What does "outstanding amounts" exactly mean? Current balance or current provisions plus write-off or just write-off amount (last option might be booked many months or years after fraudulent behaviour discovery since only provisions might be booked for long time).

- What would a gross loss be if a loan is fully repaid - zero? Always non-zero provision should be booked according to provisioning principles even if payment schedule is followed before the final maturity?

- What would be recoveries: Further instalments after write-off, reduction of provisions.

- How to consider off-balance items? These open issues should be further clarified, if credit frauds transfer under AMA is obligatory.

On article 8 (2):

- What does "rapidly recovered events" mean? Some events might be rapidly recovered only partially; should a near miss event in the original amount be collected in such case as well?

- On article 8(3), there is uncertainty as to whether the expenses are internal and external or just external. Article 7.1b1 refers to external expenses and .1b2 cost of repair.

CHAPTER III OPERATIONAL RISK MANAGEMENT

Articles 9 – 14
Article 14 Reporting

We note the following

> *The competent authority shall verify the timeliness, accuracy, and relevance of an institution's reporting systems and internal controls and shall verify that the institution's operational risk reports fully reflect identified problem areas and if they motivate timely corrective action of outstanding issues.*

We note that only timeliness, accuracy, and relevance are mentioned. Whereas we note that in the explanatory box in Article 39 that relates to supervisory assessment of data quality that in addition to those three standards there are also three other core dimensions, namely completeness, validity and consistency. Yet these are only a subset of the principles set out in the Basel Committee on Banking Supervision: Progress in adopting the principles for effective risk data aggregation and risk reporting published in December 2013. [7]

In that document it sets out the 5 principles for reporting as follows:

- ***Accuracy*** *– Risk management reports should accurately and precisely convey aggregated risk data and reflect risk in an exact manner. Reports should be reconciled and validated.*

- ***Comprehensiveness*** *– Risk management reports should cover all material risk areas within the organisation. The depth and scope of these reports should be consistent with the size and complexity of the bank's operations and risk profile, as well as the requirements of the recipients.*

- ***Clarity and usefulness*** *– Risk management reports should communicate information in a clear and concise manner. Reports should be easy to understand yet comprehensive enough to facilitate informed decision-making. Reports should include meaningful information tailored to the needs of the recipients.*

- ***Frequency*** *– The board and senior management (or other recipient as appropriate) should set the frequency of risk management report production and distribution. Frequency requirements should reflect the needs of the recipients, the nature of the risk reported, and the speed, at which the risk can change, as well as the importance of reports in contributing to sound risk management and effective and efficient decision-making across the bank. The frequency of reports should be increased during times of stress/crisis.*

- ***Distribution*** *– Risk management reports should be distributed to relevant parties while ensuring confidentiality is maintained.*

We believe that the EBA terminology causes confusion with the Basel Committee's principles that are well understood and accepted and being implemented in the IT infrastructure and in reporting. We recommend that this article is re-drafted to set out the above 5 principles consistent with the Basel Committee's guidance.

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[7] http://www.bis.org/publ/bcbs268.pdf

Specific Comments

The provisions of the articles 11(2a) and (2c) may raise issues in some jurisdictions where the respective roles of the Management Body and the Senior Management have been defined differently than what is stated in some countries.

We would like that after "the institution's Management Body" in these sub-articles, the following be inserted "or the Senior Management, given the national provisions regarding the respective roles of these two bodies",

On article 14 (1d): it is not clear why the detection of deficiencies in the policies, processes and procedures for managing operational risk should lead to ad hoc reporting rather than ad hoc validation. We suggest requiring ad hoc validation in these cases as this is more effective to improve policies, processes and procedures and prevent losses caused by these deficiencies.

CHAPTER IV OPERATIONAL RISK MEASUREMENT

Section I The four AMA elements

The Regulation clearly sets out in Article 322 the requirements with respect to the use of the four elements.

We believe it would be beneficial for the sake of completeness if the RTS was enhanced to include the Regulatory text in each of the RTS articles on the appropriate elements to avoid members having to read the Regulation as well and thus to identify any differences and or nuisances of interpretation or definition between them.

The benefit would then be that the RTS text would then enhance, expand, clarify the Regulation.

In summary, we believe that the EBA RTS is deficient because it has not taken an opportunity to provide further definition in order to move towards an approach that whilst not in complete uniformity with non-EU regulations, it is at least in harmony with and not in conflict with non-EU regulations.

We draw the EBA attention to the guidance set out by the US regulator.

- INTERAGENCY GUIDANCE ON THE ADVANCED MEASUREMENT APPROACHES FOR OPERATIONAL RISK June 3, 2011 http://www.federalreserve.gov/bankinforeg/srletters/sr1108a1.pdf

We believe that the EBA should review their draft rules in order to improve the harmonisation of the two primary regulatory jurisdictions, the EU and US. We also draw the EBA attention to the rules set out by OSFI in Canada [8].

[8] Capital Adequacy Requirements (CAR): Chapter 8 – Operational Risk http://www.osfi-bsif.gc.ca/Eng/fi-if/rg-ro/gdn-ort/gl-ld/Pages/CAR_chpt8.aspx

General principles: Article 15

The EBA is aware that institutions have established different approaches to modelling operational risk. Therefore, we are pleased to read that the EBA has not set out any prescriptive approach with regard to how the four elements are to be combined.

However, for the further avoidance of doubt, it is worth reminding the audience that the output from the model is an estimate of total loss (EL + UL) - unless EL is permitted to be deducted – based upon a forward looking time horizon of a perpetual one year period to a 99.90 confidence.

The RTS should make it clear that an institution is not required to look beyond this time horizon.

Operational Risk Categories (ORC)

We believe that the standard should state that when combining the four elements there should be an internally consistent set of "operational risk categories" (ORC) used for the four elements, that at the minimum enables aggregation to a common core set of high-level ORCs for which the own funds requirement can be calculated and compared between ORC and over time.

Reorganisation of the Articles and chapters

Also, this chapter should include the following articles that relate to measurement

Articles
7 Operational Risk Loss
8 Recorded Loss

Internal Loss Data: Article 16.

This refers to Regulation Article 322 (3)

For the avoidance of any doubt, an institution should also be able to identify the legal entity and country of operation to which the operational loss is associated.

Where the loss is an accounting loss booked in the income statement, then the recording of the loss must take place in the same legal entity and country of operation.

Recording of losses relating to Legal Risk

We believe that the RTS would benefit by explicitly including a paragraph to clarify the recording of losses relating to Legal risk. Our recommendation is the following:

- *To address these potential differences and ensure that a bank's operational risk capital reflects its risk profile, a bank should include legal losses in its quantification processes using a date no later than the date a legal reserve is established.*
- *Banks should have policies that describe their practices for collecting legal loss data and using it in the quantification process.*

We recommend that the following explanatory note is included to explain the above standard

The collection and use of legal loss data can pose challenges in the operational risk quantification process that result from factors such as the time lag that often exists between initiation and settlement of legal cases and the practices around discovery.

These losses can have a significant impact on a bank's estimate of operational risk exposure. Institutions' approaches vary for determining when a legal loss amount is included in their operational risk quantification processes.

Some institutions incorporate a legal loss amount at the time a legal reserve is created, whereas other banks incorporate legal losses at settlement.

The varying treatment of these losses across institutions could result in differences in capital requirements for similar exposures.

This is why the standard is written as defined in order to eliminate these differences

External Loss data: Article 17

This refers to Regulation Article 322 (4)

External data sources

The RTS includes the term “consortia”. Consortia are one of the sources of “external data” that can be considered for use in an AMA model. We would therefore prefer that the EBA does not refer specifically to the term “consortia”.

For example in due course the Basel Committee is scheduled to set out its approach to the Pillar 3 disclosures with respect to operational risk reporting. It is therefore possible that if in the event that the data is publically reported by institutions at a granular level, the necessity and reliance upon consortia data might diminish.

It is important that the RTS is written in such a way that other sources of data are included and that in due course if and when new sources are identified without the need to participate in consortia, that the RTS allows this.

Comparability with Internal data

We note that the EBA has set out the following standard

> 1. *The competent authority shall verify that an institution that participates in consortia initiatives for the collection of operational risk events and losses shall provide data of comparable quality, as to scope, integrity and comprehensiveness, to the internal data standards set out in Article 16.*
>
> *Information obtained from consortia initiatives which have the abovementioned characteristics are an appropriate external data source for AMA capital calculation.*

We believe that the EBA is setting the standard too high that might not enable consortia data to be used.

As the EBA is aware, the reporting thresholds for consortia data may be higher than those used by an institution in its internal loss data. Also, unless we are mistaken, there is no compulsory requirement for an institution to report exceptional losses. Furthermore although consortia data is sometimes identifiable with the losses in a specific country, in other occasions it is not. An institutions’ own business model and legal entity that is being modelled might cover more than one country and thus might not align with the consortia data.

In summary we believe that the EBA should acknowledge that there are challenges in using any external data and that some general principals should apply to enable an institution to use the data and for a competent authority to approve its use.

It would be beneficial for the RTS to set out an overall guiding standard applicable to all external data.

We recommend that the EBA reviews and includes where appropriate guidance that has already been issued by EU as well as non-EU competent authorities, in particular the US authorities.

Scaling

We are pleased that the EBA enables the use – if needed – of scaling

However, the RTS would benefit by including additional text to clarify the way in scaling must be used. For example that the institution must provide empirical support demonstrating that its scaling methodology is credible, transparent, systematic, and verifiable. If a scaling model developed by a third party (e.g., a vendor) is used by an institution to scale external data, it should be implemented, documented, and validated in the same fashion as an internally developed approach and the institution must document that the incorporation of the scaled data into its quantification processes is credible, transparent, systematic, and verifiable (as is the case for any third-party model).

We also believe that the EBA should draw attention to the need to consider inflation (and or deflation) in the modelling process to taken into account that past losses would have been based upon the scale of the operation at that time that might be different to the scale today and or anticipated in the forthcoming year.

Internal data within a Group to be used as external data

A number of institutions have within their group many subsidiaries, each of which may exhibit similar business models to the entity (or entities) that is being modelled. These entities may share common sets of employees with common processes and systems. Such institutions maintain comprehensive operational risk loss databases that enable granular comparative assessment of loss data.

For example it is possible for a EU regulated entity at the sub-consolidated level to be compared to another EU sub-consolidated entity and or a non-EU entity within the Group.

In cases where an institution decides to model operational risk at the sub-consolidated level, or even for a sub-set of an entity to cover a country or group of country operations, it is important that the EBA recognises that for such groups, other entities in the group are de facto external to that entity being modelled.

It is therefore important that the EBA explicitly recognises this capacity that some institutions have to use loss data from another part of their group to be de-facto an alternative and or complimentary set of external loss data in compliance with the RTS.

Scenario Analysis: Article 18

This refers to Regulation Article 322 (5)

Given the challenges in developing and integrating scenario analysis in an AMA model as either a direct input and or as a benchmark to validate, verify or calibrate a loss driven data model, we believe that the RTS would benefit by setting out further direction on the use of scenario analysis.

Definition

The RTS is deficient in that it does not define scenario analysis. We recommend inclusion of an appropriate definition such as:

> Scenario analysis is a systematic process of obtaining expert opinions from business managers and risk-management experts to derive reasoned assessments of the likelihood and loss impact of plausible operational losses.
>
> Scenario analysis provides a forward-looking view of operational risk that complements historical internal and external data

We agree that it is not restricted to only high severity events

Bias

We note that the EBA has listed three biases.

> *(a) the scenario process shall be clearly defined, well documented, repeatable and designed to reduce as much as possible subjectivity and biases, including anchoring, availability and motivational biases;*

The EBA has omitted overconfidence and partition dependence. These should be included..

Additional information about scenario bias can be found on pages 18-19 of Observed range of practice in key elements of Advanced Measurement Approaches (AMA), Basel Committee on Banking Supervision, July 2009 [9]

In particular, we believe that it is prudent that the EBA brings to attention the need to ensure that there is mitigation of bias and justification for loss frequency and severity estimates, which if inappropriately modelled, can have material impacts upon increasing and or reducing the modelled losses.

We recommend that the RTS either includes all 5 bias and their definitions and or at least cross references the definitions against the Basel Committee paper.

[9] http://www.bis.org/publ/bcbs160b.pdf Basel Committee on Banking Supervision: Observed range of practice in key elements of Advanced Measurement Approaches (AMA) July 2009

Mixing scenario analysis directly with internal and external data

Although as noted above we are pleased that the EBA has not set out any prescriptiveness with regard to how the four elements are combined, nonetheless, we believe that it is incumbent upon the EBA to include statements that set out the words of caution and thus matters that an institution will need to overcome if it combines scenario analysis directly within internal and or external data in a modelled frequency and severity distribution.

We recommend that the EBA reviews and includes where appropriate guidance that has already been issued by EU as well as non-EU competent authorities, in particular the US authorities.

We recommend that direction is also provided with respect to Scenario Analysis as a Benchmark and Scenario Analysis as the Base Model.

Business Environment and Internal Control Factors (BEICF): Article 19

This refers to Regulation Article 322 (6)

Definition

The RTS definition set out in paragraph 1 is deficient in that it does not define BEICF. It only lists some examples of the sources of operational risk.

We recommend that the EBA should include a definition for example

> BEICFs are indicators of an institution's operational-risk profile that reflect a current and forward-looking assessment of the institutions underlying business-risk factors and internal control environment.
>
> BEICFs are forward-looking tools that complement the other data elements in the AMA framework in developing a comprehensive risk profile.

We note that the EBA has set out some high-level standards in paragraphs 2 and 3 with respect to the general use. However, they are too general to be of use for an institution and or for a competent authority

We recommend that the EBA reviews and includes where appropriate guidance that has already been issued by EU as well as non-EU competent authorities, in particular the US authorities.

We recommend that direction is also provided with respect to

a) the use of BEICF metrics,

b) the use of BEICF in combination with the other three elements and

c) the interaction with the requirements to meet the Use Test set out in Chapter VI – Use Test.

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Section II AMA modelling assumptions

Articles 20 – 24

We do not support the exclusion of certain distributions and even copulas. We believe that the RTS has the potential to stifle modelling.

The draft RTS is far too prescriptive with respect to the identification of probability distributions and the determination of aggregated loss distributions and risk measures.

We set out the following comments that are entirely consistent with those set out by the EBF in its response.

Article 21:

(5) There appears to be a conflict between the requirement in this paragraph to use all operational risk losses and Article 21 (1) which implies that firms can construct relevant internal loss data sets.

(6) Some banks apply inflation adjustments. Thus, we suggest to remove the mandatory requirement and evaluate the use of inflation adjustment in the overall framework of the institution.

Appropriate inflation rates are very specific (real estate in different countries/cities, expenses for medical treatment, etc.). We consider finding an appropriate index for the loss events as extremely challenging. In addition we expect that such model components increase arbitrariness. Moreover, the understanding of external loss events in the database is limited and cannot be done by other institutes in a reasonable manner. Loss events from external data pools suffer anyway from unwanted scaling effects, e.g. from different business volumes, which can hardly be corrected.
For some risk categories - particularly for the significant event type 4 - finding an index appears impossible. The question "What would the loss figure be today?" is highly hypothetical and already addressed in the scenario analysis. A proper integration of scenario analysis into the capital model is much more effective than inflation adjustment.

(7), a clarification to Articles 21 (7) & (10) is requested in relation to the concrete definition of “single root event” and “root event”. Conceptually the idea is understood and appreciated, however the concern relates to the practicality and supporting a consistent approach by firms across the EU.

Depending upon the practical interpretation of “root event”, this could amend the data collection and aggregation requirements. For example, if the “root event” refers to a process / control failure (because the firm has implicitly or explicitly decided to accept the risk) then the events would be aggregated / grouped overtime. It is not clear if the time period for grouping matches the annual accounting period or crosses accounting periods. The practicalities may be similar to finding a root cause.

(8), the data set which is used for the severity model should only contain integral losses as the splitting of losses would distort severity modelling.

Events with an initial reference date outside the observation period are less relevant for the current risk profile as recent events regardless whether there have been recent adjustments of the loss amount. E.g., some legal risk can take several years to settle. After the settlement there might be a booking of a loss whereas a provision is dissolved. This does not imply that the event is relevant for the current risk profile.

We therefore suggest including only events in the AMA calculation which have a reference date within the observation period. We strongly suggest not splitting up loss amounts.
Instead of mixing different reference dates of losses we propose to extend the observation period for severity modelling. Longer observation periods would also mitigate the situation where losses fall outside the scope of AMA modelling.

Article 23

Modelling prescription: Internal models used under AMA are in essence risk sensitive. They do incentivise organizations to move up the ORM (operational risk management) learning curve and keep pace with industry changes through regular back-testing and audit process by translating ORM progress in a quantitative assessment. We do not support new and too prescriptive restrictions or recommendations for modelling choices, especially regarding the choice of distribution law or dependences modelling, given the fact that in the current practices, we have in any case to produce quantitative and qualitative evidence that our modelling choices are duly justified. We consider it is not appropriate to change this well-established practice by introducing prescriptive restrictions/recommendations irrespective to the nature of data, risk profile and the general modelling framework defined by a given entity.

Therefore the provisions contained in articles 23 (3) (loss distribution determination), article 26 (3) (dependence) and 41 (d) (use of AMA pillar I modelling place of quantitative ICAAP for OR assessment,) would lead to a very significant modification of our whole current practices and internal modelling framework

We do not support them.

The main concerned topics are:

Dependence (article 26(3)) see below.

Alignment between ICAAP and AMA models: see Chapter VI below – Use Test

Loss distribution determination (article 23 (3):

The ex-ante prioritisation of sub-exponential distributions above other functions does not seem appropriate in this connection. Moreover, the quality of loss distribution selection process is already and efficiently covered by Article 23 (6) and 23 (8) (resp. attention paid to kurtosis related parameters and prescription of goodness-of-fit tests).

The provisions described in these two articles ensure that the determination of the loss distribution pays sufficient attention to tail events.

(8): EBA seems to move to overly strong reliance on statistical measures when selecting appropriate distributions. For examples goodness of fit measures are not stable over time, as they change with new data coming in over time. Thus, frequent changes of distributions create jumps specifically in allocation of Divisions, making risk management and communication of results impossible. Thus clearer wording is required to put Article 23 into perspective.

Article 24 (4):

Competent authority shall verify that the institution applies appropriate techniques to determine the aggregated loss distributions. Therefore they should verify that the institutions apply techniques to avoid capping the maximum single loss.

It would be advantageous from EBA to precise the word “capping” to avoid confusions. It may be necessary, in some rare cases on the data structure, from a technical point of view for instance to truncate the loss distribution on the right (which is mathematically not the same as capping and hopefully from EBA not meant with “capping”) to ensure an acceptable robustness by performing sensitivity analysis, especially against very high losses.

This may occur, when the data- and so the fitted Distribution too- have far outliers (is most of the time the case by adding huge losses in a sensitivity analysis) and seem to have very high tail. When huge losses are included in the data, they can get overweight, compared to the rest of the data, because of the too short history. The best fitted Distribution (not right-truncated) may then generate unrealistic losses with a too high probability/duration.
In fact it should be permitted and appreciated from EBA to right-truncate the loss Distribution for robustness purpose, provided the truncated point can be economically validated. Such a method has the advantage to be simple to understand for controllers and transparent.

On article 24 (4), we are not completely aligned with article 21 (3) (extension of the observation period) and 24 (4) (monotonic principle). Indeed, the possibility to extend the observation period for some categories breaches the time consistency of the dataset to be modelled even as this case is already explicitly covered by the option given by the regulator to use either external data or scenario analysis.

The assumption under which a good operational risk measurement device systematically fulfils the monotonic principle seems also quite doubtful given that OR measure is not “exposure based”. Indeed risk profile may increase even if activity doesn’t grow, OR profile is in fact much more sensitive to the effectiveness of the operational risk management than to the size of business. This is also part of the critics made by the regulator to the current TSA framework.

Section III Expected losses and dependence

Expected Loss Article 25:

We note that Article 322 Quantitative Standards as follows:

2. The standards relating to process are the following:

(a) an institution shall calculate its own funds requirement as comprising both expected loss and unexpected loss, unless expected loss is adequately captured in its internal business practices.

The operational risk measure shall capture potentially severe tail events, achieving a soundness standard comparable to a 99,9 % confidence interval over a one year period;

The EBA paragraphs are as follows

1) *The competent authority shall verify that an institution meets the criteria set out in this Article in order to calculate the AMA regulatory capital only on unexpected losses ('UL'), as provided for in Article 322(2), lett. (a) of Regulation (EU) No 575/2013, and to assess whether the expected loss ('EL') is adequately captured in the institution's internal business practices.*

2) *The competent authority shall verify that an institution's estimate of EL is consistent with the EL plus UL regulatory capital calculated using the operational risk measurement system. The EL estimation process shall be done by operational risk category and shall be consistent over time.*

The EBA draft RTS is inconsistent with the EU Regulation.

The basic premise is that the calculation of the AMA is a total loss (TL) number i.e. EL + UL as set out in Article 322.

Whether an institution chooses to estimate TL to a 99.9% confidence interval directly from a single modelled distribution or whether it chooses to combine separately modelled EL and UL distributions to the required 99.90% confidence interval is up to each institution to decide.

Furthermore in the following paragraph the first mention of estimate of EL is a mistake. It should be TL i.e. Total Loss on the basis that EL+UL equals TL.

The competent authority shall verify that an institution's estimate of EL is consistent with the EL plus UL regulatory capital calculated using the operational risk measurement system

Further explanation

As set out in the EBF response that we support the following comments

There are three commonly used definitions of expected loss:

1. Statistical e.g. 50% confidence interval
2. Accounting
3. Losses that are expected

The expected loss figure derived from statistical distributions will vary with the type of distribution and the data used.
The perception is that the accounting standards narrowly define expected loss, especially with regard to the creation of specific or general reserves. Thus clearer wording for the entire Article 25 is required.

(2), (3), We understand that the EL estimation should be made per category, not for the whole bank and that the estimated EL for one category cannot offset capital for other categories.

However, in this context it is not clear what is meant by “operational risk category”.

As the assessment of the expected loss for operational risk shall be considered in the business planning, we propose to assess the expected loss on the level of an institution’s business segments.

As each institution has individual categories for operational risk modelling, most institutions will not be able to perform P&L planning on the level of operational risk model categories and will perform P&L planning on the level of business segments instead.

Dependence Article 26

We do not agree with your conclusions and or the notes in the explanatory box.

The responsibilities of an institution's AMA model development team is to determine the best fit that also adheres to the monotonic principle of risk as set out in RTS Article 24 (4).

Then in accordance with chapter VII AUDIT AND INTERNAL VALIDATION, Article 45 Audit and internal validation reviews and Article 46 Assessment of audit and internal validation to review the model's fitness of purpose taking into account the regulations set out in section II – AMA modelling assumption. These assumptions will also be reviewed by competent authorities.

The conclusion of this is that there a significant number of checks and balances in place set out in those RTS articles.

It is not the EBA's role to pre-judge and or to mandate what type of distributions and or copulas are or are not appropriate to model an operational risk category.

The second sentence in 3) "*The dependence structure shall not be based on Gaussian or Normal-like distributions*" should be deleted.

We support completely the following comments set out by the EBF

This judgment to exclude Gaussian distributions is too blunt since the dependence structure depends mainly on the way the operational risk categories are defined, on the way how data is grouped and finally how the dependence structure interact within the full modelling framework.

Firstly, the RTS should clarify to which quantity the proposed Student copula should apply. Indeed, depending on the bank, some dependence models are based on aggregate cells losses, others are based on frequencies (number of events) and others are based on severities. Given the parameters, it is well known in the literature that these three approaches lead to very different impacts.

Secondly, should the Student copula be correct for frequency dependences, it could be incorrect for aggregating loss dependences for instance.

Thirdly, the data may be compliant with the Gaussian copula and invalidate the Student copula. What would happen in this case?

Furthermore, we do not support too prescriptive restrictions/recommendations for modelling choices given the fact that we have in any case to produce quantitative and qualitative evidence that our modelling choices are duly justified (see article 26 (5)).

Concerning the explanation given in the corresponding explanatory box, it seems not that obvious one could apply lessons learned on credit and market risks directly to operational risk without any consideration of the data (see article 23 (2.a) which emphasizes the absolute necessity to study the data before taking any modelling assumption for instance) and the modelling framework.

Section IV Insurance and other risk transfer mechanisms

Articles 27 – 32

In comparison to other chapters and articles, this section is too lengthy.

Yet, given both the importance of this topic and the challenges to include any benefit from insurance and or other risk transfer mechanisms, our overriding comment is that it would be beneficial to all institutions if RTS articles 27 through 32 were re-written and structured in accordance with the content set out in Article 323

We have found it very difficult to cross reference the draft RTS text or to identity differences with the comprehensive 30-page guidance that was published by the Basel Committee in October 2010 [10].

We are concerned that the EBA may have introduced standards that are different to those set out in either the Regulation and or the Basel Committee publication that remains the established practise at this time.

We do not believe that institutions and or competent authorities should also need to read Regulation Article 323 in order to ascertain how it is to comply with the article.

Also we believe that the RTS should explicitly state that the standards agree with the text set out in the Basel Committee paper and that if in doubt an institution should be guided by the Basel committee text.

[10] http://www.bis.org/publ/bcbs181.pdf
Recognising the risk-mitigating impact of insurance in operational risk modelling

Section V Capital Allocation

Article 33

The approach to capital allocation is set out in the Regulation Article 20: *Joint decisions on prudential requirements.*

It states

> *1. The competent authorities shall work together, in full consultation:*
>
> *The application referred to in Article 312(2), shall include a description of the methodology used for allocating operational risk capital between the different entities of the group.*
>
> *The application shall indicate whether and how diversification effects are intended to be factored in the risk measurement system.*

We believe that the RTS should include a reference to this Article.

Approach for institutions operating only within the EU

From our reading of the proposed draft RTS what it is saying is as follows:

Where an institution is calculating the own funds on a consolidated basis, and where a competent authority authorises the inclusion of that value in the calculation of the consolidated own funds requirement in order to calculate a consolidated capital ratio then, it is possible to replace the calculation of the own funds requirement of a subsidiary that would be calculated using the Standardised Approach / BIA with an allocation of the overall consolidated own funds requirement

We note that in paragraphs b), c) and d) the EBA sets out its requirements in order for this to happen. We support this approach.

Approach for institutions operating also outside the EU

We need to bring to your attention that the approach that the EBA has set out cannot be mandated to an institution that has operations in the form of legal entities and or branches that are treated as legal entities for the capital framework that are outside the EU.

The fact is that a EU competent authority has no authority to prescribe the minimum capital to be maintained outside the EU. It may well be that the EU competent authority and the non-EU competent authority might come to an arrangement to allow the calculation of the local non-EU own funds requirement based upon an allocation of the consolidated modelled value. If so then the RTS would be appropriate.

However, the EBA will be aware that this will be an exception to the general rule that non-EU competent authorities do not allow this approach. They require the calculation of operational risk capital to be local.

Thus it well understood that EU institutions need to take into account the guidance from non-EU regulators and for example the US regulators when developing AMA models, in order to ensure that the group approach is acceptable to non-EU and the US authorities who mandate that any AMA model calculates the OFR for the Operational risk on a standalone ring-fenced basis for the institution's local operations where these are measured.

Conclusion

The EBA RTS should be updated to give direction that before an institution sets out to model operational risk, it should first understand the approach the competent authorities will take in every jurisdiction in which it is regulated for capital adequacy (i.e. is required to calculate the own funds requirement for operational risk).

The reality is that this will influence the modelling approach that an institution will adopt, either a top-down consolidated approach that is usual for a single point of entry (SPE) legal entity structure or a bottom up approach that is usual for a multiple point of entry (MPE) legal entity structure

Section VI Parallel Running

Articles 34 – 36

Although it is not explicitly stated, we are concerned that an implicit implication is that once an institution has obtained approval to report its own funds requirement utilising the AMA model that it no longer needs to calculate the number using the less sophisticated approaches.

We believe that for the avoidance of doubt the institution should continue to calculate the own funds requirement on an on-going basis in accordance with the same approach it had in place during the parallel run and before the AMA model approval.

Not only might it be needed to comply with Regulation Article 313 (Reverting to the use of a less sophisticated approach), but one needs to bear in mind that it is possible that the Basel Committee might revise the calculation using the BIA and or the TSA.

We consider that it would be imprudent for an institution to stop that calculation. Thus, we consider it prudent to require the continued calculation of the prior approaches.

Regulation Article 500: Transitional provisions – Basel I floor

We draw the attention of the EBA to the above article that an institution will need to bear in mind when implementing AMA mode.

We recommend that the RTS includes a cross reference to this article that is much more than Basel 1 floor but embraces transition of approaches within the CRD framework

Application of the RTS to extensions / changes to an AMA model

We assume that Article 34, 35 and 36 apply for institutions that intend to move to AMA from a simpler regulatory methodology (e.g. BIA or TSA).

We anticipate it does not refer to extensions or changes to AMA (including changes of IT systems) for institutions that already have permission to use AMA, especially as there is no corresponding article in Regulation (EU) No 529/2014. Our views and proposals are as follows:

In case of first introduction of AMA within an institution: agreement on the EBA's proposal of a one year post implementation parallel run, above the existing pre-implementation parallel run.

In case of material changes of an already validated AMA model: No post implementations parallel run. As per Art 34.1, the competent authorities will already get an assessment of the impacts through a pre implementation parallel run. When the permission is granted, running a post implementation parallel run, which implies operating several AMA models in parallel, appears far too complex, from an operational and IT perspective, notwithstanding the fact there maybe overlapping AMA changes within this one year period.

In case of roll out of an authorised AMA model to a new entity within the institution, no post implementation parallel run. The reasons are the same as exposed for the previous case: existence of a pre implementation parallel run plus complexity of running several AMA model (the extension to a new entity may also impact the allocation of the AMA capital requirement to the different entities including AMA ones before the supplementary roll out).

CHAPTER V DATA QUALITY and IT INFRASTRUCTURE

Articles 37 – 40

The EBA has set out the following standards: Completeness, Relevance, Timeliness, Validity, Accuracy, and Consistency.

We draw the EBA attention to the comments already set out above on Article 14 – Reporting

The EBA has introduced a new set out standards that are different to and only a subset of the principles set out in the Basel Committee on Banking Supervision: *Progress in adopting the principles for effective risk data aggregation and risk reporting* published in December 2013. [11]

Our view that is that the EBA RTS causes confusion by introducing a set of standards different to those set out by the Basel Committee that have been adopted by institutions.

We urge the EBA to re-draft Chapter V to ensure consistency with and harmonisation with the Basel Committee's approach that we support completely.

In the Committee's paper in addition to the five principles of accuracy, comprehensiveness, clarity and usefulness, frequency, and distribution, sets out the following standards

> ***3.1 Governance and infrastructure***
>
> *Principle 1 – **Governance** – A bank's risk data aggregation capabilities and risk reporting practices should be subject to strong governance arrangements consistent with other principles and guidance established by the Basel Committee.*
>
> *Principle 2 – **Data architecture and IT infrastructure** – A bank should design, build and maintain data architecture and IT infrastructure which fully supports its risk data aggregation capabilities and risk reporting practices not only in normal times but also during times of stress or crisis, while still meeting the other Principles.*
>
> ***3.2. Risk data aggregation capabilities***
>
> *Principle 3 – **Accuracy and Integrity** – A bank should be able to generate accurate and reliable risk data to meet normal and stress/crisis reporting accuracy requirements. Data should be aggregated on a largely automated basis so as to minimise the probability of errors.*
>
> *Principle 4 – **Completeness** – A bank should be able to capture and aggregate all material risk data across the banking group. Data should be available by business line, legal entity, asset type, industry, region and other groupings, as relevant for the risk in question, that permit identifying and reporting risk exposures, concentrations and emerging risks.*
>
> *Principle 5 – **Timeliness** – A bank should be able to generate aggregate and up-to-date risk data in a timely manner while also meeting the principles relating to accuracy and integrity, completeness and adaptability. The precise timing will depend upon the nature and potential volatility of the risk being measured as well as its criticality to the overall risk profile of the bank.*

[11] http://www.bis.org/publ/bcbs268.pdf

The precise timing will also depend on the bank-specific frequency requirements for risk management reporting, under both normal and stress/crisis situations, set based on the characteristics and overall risk profile of the bank.

*Principle 6 – **Adaptability** – A bank should be able to generate aggregate risk data to meet a broad range of on-demand, ad hoc risk management reporting requests, including requests during stress/crisis situations, requests due to changing internal needs and requests to meet supervisory queries.*

CHAPTER VI USE TEST

Articles 41 – 44

The role of BEICF

The RTS makes no mention as to role of BEICF.

We recommend that a specific set an article setting out the standard should be incorporated.

We recommend that the EBA reviews and includes where appropriate guidance that has already been issued by EU as well as non-EU competent authorities, in particular the US authorities.

Article (42)(d)

We support the idea of using the operational risk system for ICAAP purposes.

We suggest the EBA to elaborate more to which extent the AMA model has to be used for ICAAP purposes.

We think the opportunity should be left open to each institution to use or not the AMA model for assessing its ICAAP.

However, the EBA need to bear in mind that an institution may have a different confidence interval to 99.90% for internal capital adequacy

CHAPTER VII AUDIT AND INTERNAL VALIDATION

Articles 45 – 46

This chapter refers explicitly to the role of the competent authority in reviewing the institutions' AMA model.

Thus the RTS is deficient because it does not contain any standards setting the role of the independent model risk review function and or the internal audit function.

It is inappropriate for institutions to have to deduce from this chapter the roles and responsibilities for these functions.

Therefore, we recommend that an additional chapter is included that sets of the role of these two functions when looked at from the institution's own perspective

We recommend that the EBA reviews and includes where appropriate guidance that has already been issued by EU as well as non-EU competent authorities, in particular the US authorities.

We recommend that the topics to be included would cover the general direction on validation, validation of governance and data elements, validation of the BEICF, validation of quantification systems, and the role of Internal Audit. For example:

Article 45 (2)

We request the frequency to be changed to a risk-based approach over a multiannual audit cycle. We agree and understand the need for having a strong and periodic audit and internal validation of the AMA system. According to standard principle governing the activities of the internal audit, missions are planned over a cycle of some years, i.e. more than one year, in consideration of the risk involved and based upon a Risk Based Audit Plan.

Requesting an "at least annual" audit is not in line with this principle.

Furthermore in view of the size of the banking groups involved, it is very difficult to check every year all the items mentioned in the article 45 - 2 - b) for all the group entities at a detailed level.

We propose to change paragraph 2 to:

> *"In particular, the competent authority shall verify that (a) at least on annual basis the internal validation function provides a reasoned and well-informed opinion on whether the operational risk measurement system works as predicted, and whether the outcome of the model is suitable for its various internal and supervisory purposes; (b) on a regular basis the audit function verifies the integrity of the operational risk policies, processes and procedures assessing whether these comply with legal and regulatory requirements as well with established controls and verifies the functionality of internal processes for the validation hereof. For this purpose, emphasis shall be provided to the verification of the quality of the sources and data used for operational risk management and measurement purposes."*

CHAPTER VIII INAL PROVISIONS

Article 47 Entry into force

Requirements with respect to Fraud Risk

As already set out in our comments to Article 6, we completely disagree with the following draft RTS

> *Article 6(1) shall apply after two years from the entry into force of this Regulation. Article 6(3) shall apply after one year from the entry into force of this Regulation.*

Effective date for compliance

With regard to the following draft RTS statements

> *This Regulation shall enter into force on the twentieth day following that of its publication in the Official Journal of the European Union. For the institutions already using an AMA for regulatory purposes, this Regulation shall apply after one year from its entry into force.*

We note that in accordance with Regulation Article 312.

> *EBA shall submit those draft regulatory technical standards to the Commission by 31 December 2014.*

Therefore at this time there is no definitive date when the RTS would come into force. It is though most probable that it will be effective sometime in January 2015.

It is therefore inappropriate that for the institutions already using an AMA for regulatory purposes, this Regulation shall apply after one year from its entry into force i.e. on a date sometime in January 2016.

As the EBA will have read in this response, we have many serious concerns with regard to the current draft and would like to see many changes and a re-draft before submission to the Commission.

It will only be after the RTS comes into force will it be possible for institutions to assess all of the implications and ramifications upon its existing AMA model and or its current project to complete an AMA model.

We estimate that an institution will need at least 9 months to conduct that review in order to determine its approach to the measurement of operational risk.

The conclusion of that review for institutions with an approved AMA model (and also those in parallel running) will be 1) the current model is compliant or 2) the current model needs changing.

It is quite possible that an impact might be that there could be an implication upon the loss gathering process.

It would be impractical to mandate an institution to update its loss data base to retrospectively to taken into account new rules,

The consequence would that institutions would then need to wait for a further period of three to five years to model the risk in accordance with Article 322 (3) (a).

There would also be a need to ensure that external loss data is consistent within this standard.

It is possible that an institution might decide whether to apply for reversion to use of a less sophisticated approach in compliance with Regulation Article 313.

For those institutions that have an AMA model project in place at the time the RTS comes into force will also need to conduct the same assessment.

In conclusion we consider that no matter when the RTS comes into force anytime between now and the 20th of January 2015, the earliest date from which the RTS should be applied should be based upon the following

If the EBA were conclude that RTS Article 6 was to be mandatory, then the earliest date for compliance would 1st January 2023.

This is because institutions would need to spend 2015 preparing changes to the collection of and recording of loss data to be effective 1st January 2016. Then there would need to be 3 to 5 years of new unpolluted loss data (years 2016 through to 2020). Then institutions would need to develop the revised AMA models (and at the same time adjust it Credit Risk modelling)

However, if the EBA were to set out an RTS in compliance with the Regulation and thus to provide an option to institutions, then the effective date should be 1st January 2017, thus allowing institutions two years to a) either achieve compliance and or b) to reach an agreement with its EU competent authorities to revert to a less sophisticated approach.

END