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VH/MM/B02

**EACB Note
on
draft RTS on assessment methodologies for the Advanced Measurement
Approaches for operational risk under Art. 312 CRR (EBA/CP/2014/08)**

The members of the EACB welcome the EBA draft RTS under Art. 312 CRR aiming to reduce differences in the calculation of requirements for operational risk under the Advanced Measurement Approaches (AMA) and to better match the AMA with the banks' operational risk profile. However, we would like to highlight that it is important that the objective of the standard shall not be to issue strict rules at the expense of good risk management.

1. Possible impacts on non-AMA banks

With regard to the applicability of the standard we would like to point out that although the proposed RTS is aimed to AMA banks, the regulation is likely to impact non-AMA banks. We believe that, in this respect, the standard should be more carefully balanced and provide more flexibility, in order to avoid any effect on the calculation of the capital charge for banks applying the standardised approach to operational risk (STA) or Basic Indicators approach (BIA).

One source of impact would be the decrease of capital held for credit risk and calculated under IRB due to an increase of capital under AMA and most likely also under the STA and the BIA (that would be adapted to reflect the new AMA approach).

Another source of impact would derive from the further specification on scope and definitions of loss event registration (legal risk, market-related activities, article and fraud credit related, article 4, 5, and 6) that is provided in the draft RTS and that would affect also the standardised models.

The EBA should made clear that the specifications introduced for the AMA approach would not affect, at least for the time being, the calculation under the STA and BIA approach.

2. Implementation challenges

The draft RTS is also likely to pose an implementation challenge. More regulatory specification intensifies the implementation efforts for operational risk. While improved guidance is welcome, more detailed rules might increase the attention of banks on preventing auditable issues at the expense of focusing on adding value of operational risk activities to the business. Stricter follow-up of existing principles and rules should prevail over more detailed rules.



2. Other specific comments

We believe that a number of provisions should be clarified in order to avoid ambiguities and to allow a more effective implementation process.

Under Art. 2(27) of the draft RTS regarding “timing losses”, the wording “accounting period” should be amended as to “annual accounting period”, in order to have a clear term of reference.

With regard to Art. 21 on the building of the calculation data set, we believe that a clarification is needed in para. (4), with regard to the reference dates. The use of ‘date of discovery’ or ‘date of accounting’ is incorrect for estimating dependencies (correlation). The proposed dates do not express the simultaneous occurrence of the actual event. Also, the use of these dates might cause unwanted variability in the AMA incident frequencies. Therefore, we would prefer to use the ‘occurrence date’ in the calculation dataset for severity and correlation. To mitigate the late reporting biases or omissions other solutions are available.

3. Answers to specific questions

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 proposed rule would imply a realignment of the boundaries of credit risk and operational risk. This could prove extremely difficult as there are currently differing practices in this respect, and the impact of this rule may therefore even go beyond the AMA approaches. The change will have an impact upon regulatory capital calculations and the capital estimates generated as a result. This will have an impact upon Credit Risk Management functions. The Credit Risk Management functions cannot be expected to make such significant changes if the changes are not actively supported by coherent regulation on Credit Risk. It is anticipated that a Regulatory Technical Standard will be published on Credit Risk. It is of the utmost importance that the provisions there contained are in line with the requirements specified under Article 6 of this draft RTS.

As a consequence of this article and the provisions on implementation, a retroactive application could occur and available databases would have to be modified. A double-counting of the same events under operational risk and credit risk would have to be avoided.

With regard to the possible overlaps between credit risk and operational risk, we understand and support the managerial aspect of managing these events within ORM. However, ORM AMA capital calculation is less certain and more volatile than existing Credit capital calculation. Moreover, this treatment requires a substantial change in the existing data collection and modelling processes in the Credit Risk area and to a lesser extent in Operational Risk. Beside this, the consequences regarding actual capital charges



are unknown for both Credit Risk and Operational Risk, while the benefits achieved with this change of regulation are unclear.

It is also unclear the level of granularity at which these requirements shall be applied: whether at the level of single transactions or, once a fraud has been detected, to all transactions involving the same product or all transactions across all products with the same customer. Similarly, there is no indication for a threshold at which this data is to be captured. The ORX Operational Risk reporting Standards currently use a threshold of € 500.000. If the threshold for investigating whether a credit loss is a fraud or not is reduced significantly, then the resources required for the assessment could increase substantially. Moreover, we see also an issue of skilled resources to determine whether a fraud has or not occurred. Currently the determination of frauds involves forensic accounting skills. It is not clear if a credit department would already have the level of resources required to conduct the analysis on this potential volume of losses. The choice of initial data collection threshold, for these losses, will heavily influence whether two years is sufficient time to begin data collection. A further question is related to uncertainty in relation to who will be charged with the burden of proving the fraud relation in credit related cases.

Article 6 of the draft RTS, Fraud events in the credit area, does not seem in line with article 322(3)(b) CRR. In fact, under Art. 322(3)(b) it is required that risk losses which are identified separately and included in the internal credit risk database within the operational risk, shall not be subject to the operational risk charge provided that the institution treats them as credit risk for the purpose of calculating own funds requirements.

Finally, we are also concerned about the definitions relative to credit fraud events, and especially of "first party fraud" and "third party fraud". We believe that the practical application of this rule to a variety of fraud cases would lead to numerous difficulties. Moreover, already Art. 6(4)(1) of the draft RTS should be clarified when referring to the definition of "first party fraud". In fact, it is unclear whether it distinguishes two cases ("when the party misrepresents its financial abilities on the application forms and by using another person's identifying information") or one scenario with two conditions.

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?

Prohibiting completely to base the dependence structure on Gaussian or Normal-like distributions might be too far-reaching. We understand that the credibility of modelling has to be restored following the crisis and that many operational risk events are tail events. However research suggests little proof for the existence of tail correlation and stating that the Gaussian copula does not appear well suited seems arbitrary.



Although Gaussian copula did understate the Market and Credit Risk tail events, this fact cannot simply be extrapolated to Operational Risk due to differences in risk types. Moreover, tail events drive operational risk but are generally isolated single incidents and not the sum of a correlated set of incidents.

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