European Banking Authority

Consultation paper on BI-related mandates for Operational Risk

Public hearing - 20 March 2024

Guidance for participants

- Please note that microphones are muted on entry. Kindly keep yourself muted during the presentation.
- Do not start your camera if you are not the speaker. To increase audio quality, please turn off video streaming.
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  - Raise your hand on Teams and when the floor is given to you, identify yourself by providing your full name (unless already used in Teams) and name of your organisation.
  - Or indicate in the Teams chat your name and on which topic you'd like to intervene or write your question / comment directly in.
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  - Log out and log in again;
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Welcome and introduction

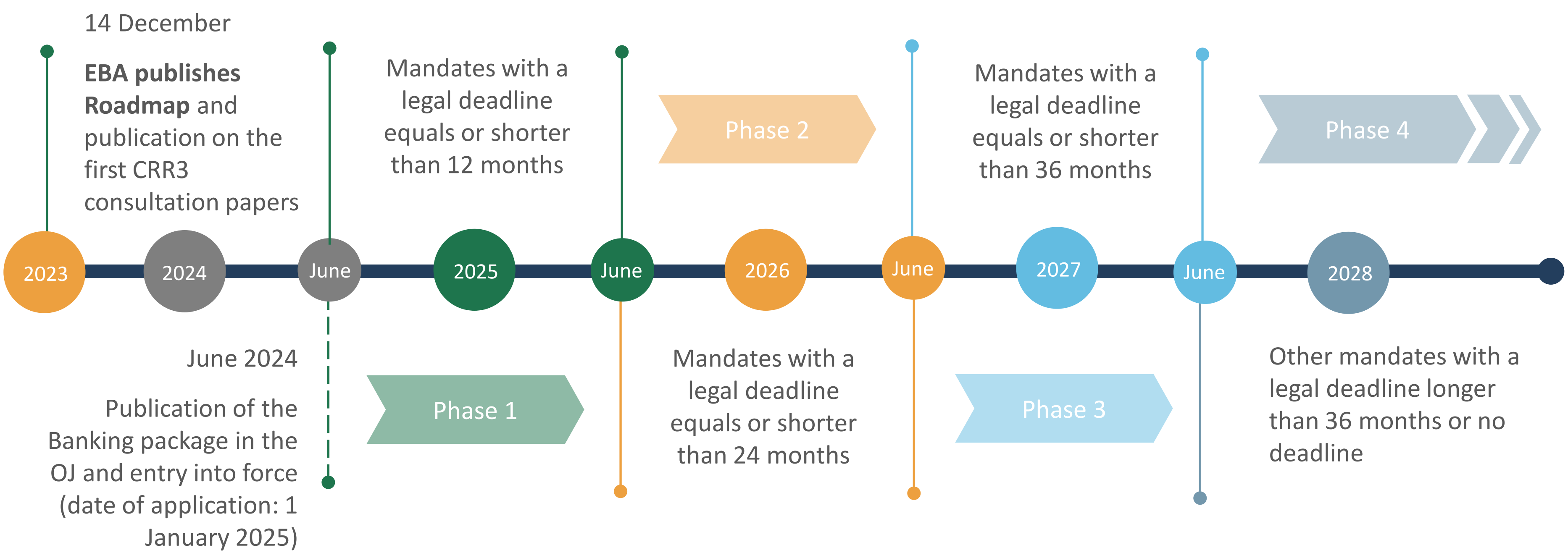
EBA roadmap on strengthening the prudential framework

The EBA roadmap on strengthening the prudential framework was published in December 2023 (link)

Main objectives:

- Providing clarity to the industry on how it will develop the mandates implementing the legislation
- Showing how the EBA expects to finalise the most significant components ahead of the application date
- Setting out EBA policy work for the Banking package
- Intended as a useful reference for industry and other stakeholders in their own implementation efforts

Sequencing in four phases of 12 months each



Operational risk

Phase 2

Business indicator calculation

These mandates relate to the calculation of the business indicator, the definition of the sub-items and the mapping to FINREP.

Phase 3

Loss classification

This group covers the mandates related to the taxonomy of operational risk losses as well as exclusions and adjustment of their calculation.

Phase 4 and later

Operational risk management

These mandates cover governance arrangements to maintain the loss data set as well as the operational risk management framework.

Timeline for CP on BI-related mandates

Timeline

June 2024

- Publication of the Banking package in the OJ and entry into force (date of application: 1 January 2025)

20 February 2024

Publication

- Consultation papers on policy aspects, reporting and disclosures

20 March 2024

Public hearing

21 May 2024

End of public consultation

End-2024

- Finalisation of the draft TS and submission to the EC

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Draft BI-related mandates

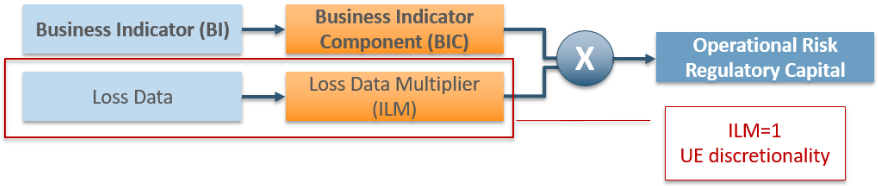
European Banking Authority

Operational risk framework – what changed?

Current approach for calculation of own funds requirements for operational risk	CRR3 proposal for calculation of own funds requirements for operational risk (Art. 312)

Three approaches:

1. BIA – Basic indicator approach
2. TSA/ASA Standardised/Alternative standardized approach
3. AMA Advanced Measurement Approaches



$$BIC = \begin{cases} 0.12 \cdot \mathrm{BI}, & \text{where } \mathrm{BI} \leq 1 \\ 0.12 + 0.15 \cdot (\mathrm{BI} - 1), & \text{where } 1 < \mathrm{BI} \leq 30 \\ 4.47 + 0.18 \cdot (\mathrm{BI} - 30), & \text{where } \mathrm{BI} > 30 \end{cases}$$

Draft RTS on BI items (Article 314(6)(a) and (b) of the CRR)
Draft ITS on FINREP mapping (Article 314(7) of the CRR)

Draft RTS on the components of the BI under Article 314(6)(a) of the CRR and the elements to be excluded from the BI under Article 314(6)(b) of the CRR

- A list of typical items has been developed for each component of the BI
- Main source: work carried out by the EBA in response to EC's CfA and published in the "EBA Policy Advice on the Basel III Reform: Operational Risk"
- Limited further changes reflect subsequent amendments in accounting standards, as well as feedback received via various interactions with the industry

Structure of the draft RTS:

- Chapter 1 (Articles 1 to 4): ILDC
- Chapter 2 (Article 5 to 8): SC
- Chapter 3 (Article 9 to 15): FC
- Chapter 4 (Article 16): Elements to be excluded from the BI

Draft RTS on the components of the BI under Article 314(6)(a) of the CRR and the elements to be excluded from the BI under Article 314(6)(b) of the CRR

Chapter 1: ILDC (in line with Article 314(2) of CRR3)

$$ILDC = \min(IC, 0.0225 * AC) + DC$$

- **IC (Interest and leases Component):** the institution's interest income from all financial assets and other interest income, including finance income from financial leases and income from operating leases and profits from leased assets, minus the institution's interest expenses from all financial liabilities and other interest expenses, including interest expense from financial and operating leases, depreciation and impairment of, and losses from, operating leased assets, calculated as the annual average of the absolute values of the differences over the last three financial years;

- **AC (Asset Component):** the sum of the institution's total gross outstanding loans, advances, interest bearing securities, including government bonds, and lease assets, calculated as the annual average over the last three financial years on the basis of the amounts at the end of each of the respective financial years;

- **DC (Dividend Component):** the institution's dividend income from investments in stocks and funds not consolidated in the financial statements of the institution, including dividend income from non-consolidated subsidiaries, associates and joint ventures, calculated as the annual average over the last three financial years.

Draft RTS on the components of the BI under Article 314(6)(a) of the CRR and the elements to be excluded from the BI under Article 314(6)(b) of the CRR

Chapter 2: SC (in line with Article 314(3) of CRR3)

$$SC = \max(OI, OE) + \max(FI, FE)$$

- **OI (Other operating Income):** the annual average over the last three financial years of the institution's income from ordinary banking operations not included in other items of the business indicator but of similar nature;
- **OE (Other operating Expenses):** the annual average over the last three financial years of the institution's expenses and losses from ordinary banking operations not included in other items of the business indicator but of similar nature, and from operational risk events;
- **FI (Fee and commission Income):** the annual average over the last three financial years of the institution's income received from providing advice and services, including income received by the institution as an outsourcer of financial services;
- **FE (Fee and commission Expenses):** the annual average over the last three financial years of the institution's expenses paid for receiving advice and services, including outsourcing fees paid by the institution for the supply of financial services, but excluding outsourcing fees paid for the supply of non-financial services.

Draft RTS on the components of the BI under Article 314(6)(a) of the CRR and the elements to be excluded from the BI under Article 314(6)(b) of the CRR

Chapter 3: FC (in line with Article 314(4) of CRR3)

$$FC = TC + BC$$

- **TC (Trading book Component):** the annual average of the absolute values over the last three financial years of the net profit or loss, as applicable, on the institution's trading book, defined as appropriate either in accordance with accounting standards or, in accordance with Part three, Title I, Chapter 3, including on trading assets and trading liabilities, from hedge accounting, and from exchange differences;

- **BC (Banking book Component):** the annual average of the absolute values over the last three financial years of the net profit or loss, as applicable, on the institution's non-trading book, including on financial assets and liabilities measured at fair value through profit and loss, from hedge accounting, from exchange differences, and realised gains and losses on financial assets and liabilities not measured at fair value through profit and loss.

- Two approaches:
  - **Accounting Approach (AA):** the net gains and losses from the accounting trading portfolio are assigned to the TC and the net gains and losses from the accounting non-trading (i.e. banking) portfolios are assigned to the BC; and
  - **Prudential Boundary Approach (PBA):** the items of the TC and of the BC are adjusted according to the rules envisaged in the prudential boundary framework of the CRR

Draft RTS on the components of the BI under Article 314(6)(a) of the CRR and the elements to be excluded from the BI under Article 314(6)(b) of the CRR

Chapter 4: Items excluded from the BI (in line with Article 314(6)(b) of CRR3)

- List of items to be excluded – Article 314(5) of CRR3
- Several precisions:
  - **income and expenses from insurance or reinsurance business** to be excluded from the calculation of the BI, as referred to in Article 314(5)(a) of the CRR:
    - are those where an institution acts as an insurance provider, therefore taking on the insurance risk;
    - where instead an institution sells or distributes insurance products or services to its clients, the income and expenses are to be included within the BI, since these products or services are conceptually not different, under an operational risk perspective, from financial products or services.
  - **certain financial impacts related to lease assets or resulting from operational risk events, or the outsourcing fees paid for the supply of financial services**:
    - might be accounted under some items (administrative expenses, including staff expenses, depreciation of tangible assets, amortisation of intangible assets, impairment or reversal of impairment) that, according to Article 314(5) of the CRR, should not contribute to the BI. In such cases those financial impacts shall not be excluded from the calculation of the BI.

Draft ITS on mapping to FINREP in line with Article 314(7) of the CRR

- Need for harmonised interpretation and adoption of the BI across EU jurisdictions
- Need to limit BI’s implementation/ administrative/ operational costs for the EU institutions
- Based on proposal put forward in the response to EC’s CfA and published in the “EBA Policy Advice on the Basel III Reform: Operational Risk”
- The choice of FINREP was motivated by the fact that FINREP templates are developed to account for both IFRS and for national accounting frameworks (NGAAP).
- Limited further are suggested to make templates fully aligned with the institutions’ practice to report the several BI items according to the FINREP standards
- References can be exact or, for certain BI items, approximate in reason of the adjustments to be done to the FINREP ones to reflect the qualifications envisaged by the CRR for the calculation of those BI items

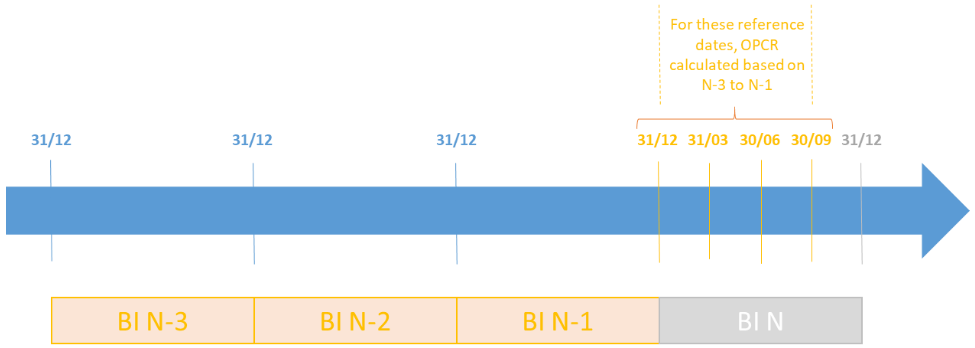
Overview of the questions for consultation

- **Question 1:** What are your views with regards to the proposal for the ILDC component? Please explain and provide arguments for your answer.
- **Question 2:** What are your views with regards to the proposal for the Services component? Please explain and provide arguments for your answer.
- **Question 3:** What are your views with regards to the proposal for the Financial component? To which extent are you carrying out operations or making accounting choices as referred to under paragraph 2, point a) of Article 9 of this draft RTS? Are you carrying out operations or making accounting choices, other than those specified under paragraph 2, point a) of Article 9 of this draft RTS, that could justify the use of the PBA? Please explain and provide arguments for your answer.
- **Question 4:** What are your views with regards to the proposal for the specification of the items to be excluded from the BI? Please explain and provide arguments for your answer.
- **Question 5:** What are your views with regards to the proposed mapping of the BI items to the FINREP cells? Please explain and provide arguments for your answer.

Draft RTS on BI adjustments (Article 315(3) of the CRR)

Draft RTS on BI adjustments (Article 315(3) of the CRR)

- Each component of the BI is calculated as "the annual average over the last three financial years", meaning that the operational risk capital requirements are the same from the 31/12 of year N-1 to the 30/09 of year N and shall be calculated based on N-1 to N-3 audited financial statements of the institution
- From a risk perspective, the merger, acquisition or disposal of entities or activities may affect the operational risk profile of the institutions and may not be sufficiently reflected under the standard methodology
- The changes in operational risk exposures may require different approaches, not necessarily on a symmetric basis, for mergers and acquisitions as compared to disposals



Draft RTS on BI adjustments (Article 315(3) of the CRR)

Structure of the draft RTS:

- Article 1: Calculation of the Business Indicator adjustment in case of mergers and acquisitions
- Article 2: Calculation of the Business Indicator adjustment in case of disposals
- Article 3: Timing for business indicator adjustments in case of disposal
- Article 4: Conditions for authorizing the adjustment of the business indicator following a disposal and necessary documentation

Draft RTS on BI adjustments (Article 315(3) of the CRR)

The methods to determine the adjustment in case of mergers or acquisition and the conditions under which an entity or an activity can be excluded should be tailored to the institution's effective risk profile while ensuring both sufficient harmonisation across the EU and realistic operational implementation

- Calculation of the business indicator adjustment for M&As:
  - Historical information related to purchased entities or activities may not be available or accurate
  - Principle: use the audited financial information over the last three years
  - Alternative calculation approaches: three alternatives; institutions should use the most conservative in terms of operational risk regulatory capital

- Calculation of the business indicator adjustment for disposals:
  - Historical information over the past three years is available
  - Principle: reflect the disposal in the BI covering the three years period that is relevant
  - The items related to disposed entity have however to be adjusted if the historical financial statements are not accurate due to restructuring operations conducted prior to the disposal and resulting in maintaining part of the activity within the disposing institution

Draft RTS on BI adjustments (Article 315(3) of the CRR)

Conditions for authorizing the adjustment of the business indicator following a disposal and necessary documentation:

- Operational losses: how that entity or activity contributed to the institution operational risk losses over past;
- Guarantee commitment and future liabilities: whether the transaction agreements or any side agreements provide that the disposing institution or disposing group is commit-ted to provide any compensation for losses or future liabilities which could arise from events that took place prior to the transaction and not known at the time of the transaction;
- Operational risk exposures: whether the disposal results in significant additional expo-sure to operational risk or change in operational risk management structure that would undermine its capacity to identify, measure and mitigate the operational risk (e.g. change in IT systems, transfer of resources, and other reorganization aspects post trans-actions).

- List of documents needed

Draft RTS on BI adjustments (Article 315(3) of the CRR)

Timing for adjustments:

- The BI should be updated at the first reference date after the acquisition or merger being effective.
- For the disposal of an entity or activity and subject to authorization to be granted, the BI should be adjusted at the first reference date after the authorization is received or at the first reference date after the disposal is effective (if the authorization is provided before the completion of the operation).

Materiality:

- Multiple mergers, acquisitions, and disposals taking place throughout the year require multiple adjustments to the BI based either on financial information over the last three years or on proxy data when a full three-year historical data series is not available
- Several aspects discussed in the CP, as well as data collection pending

Overview of the questions for consultation

- **Question 6:** What are your views with regards to consider the financial statements used for the final valuation as the only reference for the acquisition of activities under the baseline approach (i.e. full historical data)? Please explain and provide arguments for your answer.
- **Question 7:** What are your views with regards to the proposed three alternative calculation approaches instead of a unique alternative approach to be defined? Please explain and provide arguments for your answer.
- **Question 8:** What are your views with regards to not providing any alternative method but adjustment to the effective perimeter of the disposal? Please explain and provide arguments for your answer.
- **Question 9:** What are your views with regards to the inclusion of a threshold? Please explain and provide arguments for your answer, as well, if applicable, further evidence on situations where BI adjustments as set out under articles 1 and 2 would not be feasible or deemed excessively cumbersome and identify potential consequences on the dynamics of the European financial markets.
- **Question 10:** What are your views with regards to the basis for the calculation of the threshold? Please explain and provide arguments for your answer.
- **Question 11:** What are your views with regards to the level you consider would be appropriate for the threshold? Please explain and provide arguments for your answer.

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Q&As

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Any further questions and/or comments:

Ruxandra.Louzas@eba.europa,eu

Giovanni.Tirino@eba.europa.eu

Gabriel.Cardi@eba.europa.eu

Thank you!