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The Committee of European Banking Supervisors
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October 2005

Dear Sirs

CEBS CP10: Guidelines on the implementation, validation and assessment of Advanced Measurement (AMA) and Internal Ratings Based (IRB) Approaches

The London Investment Banking Association (LIBA), the International Swaps and Derivatives Association (ISDA) and the British Bankers' Association (BBA) welcome the opportunity to comment on the proposed "Guidelines on the implementation, validation and assessment of Advanced Measurement (AMA) and Internal Ratings Based (IRB) Approaches" published in July 2005. Our combined membership represents a diverse group of internationally active financial institutions, operating across the broad spectrum of European and international capital markets. Many of these firms are at an advanced stage of their Basel II implementation work, and some have already progressed to an informal application stage with their "Home" supervisor. These firms are also facing significant challenges from the implementation of other measures filtering down from the EU's Financial Services Action Plan, and are only too aware of the threat of a continuing diversity of regulatory requirements. We therefore encourage much closer cooperation and coordination between supervisors throughout Europe and across the world, with a view to reducing the regulatory burden and avoiding as much duplication as possible.

In general, we support the notion of a "common understanding" on financial regulation among supervisors both in Europe and beyond. In particular, we support the need for a "common understanding" among supervisors on the procedures to be used in processing, assessing, and approving of firms' applications to use an AMA or an IRB approach for regulatory capital purposes. We also believe in a common understanding on the principles underpinning the requirements for using these approaches as set out in the Capital Requirements Directive (CRD) and in the new Basel Accord. The CP in certain areas appears to 'gold plate' the requirements of the CRD. Additionally, CP10 allows regulators at a national level to impose additional stricter requirements. Given the proposals contained within the EU Commission's Green Paper on Financial Services Policy (2005-2010) we do not consider this approach appropriate. We urge CEBS to focus agreement on a common understanding of the minimum requirements for implementation.

In this letter, we outline our major concerns about the proposals in the section on "key messages" below, and then in the appendices we attempt to provide comments specifically requested on the questions included in the "Executive Summary", and we address each section of CP10 individually, in more detail.

Key Messages

We understand that the paper is drafted as guidance for supervisors, with recognition that this will affect institutions seeking to adopt the IRB and AMA approaches. However, we recommend CEBS state more clearly the objectives of the paper and the expectation of CEBS with regard to the implementation in national regulatory frameworks once its contents have been finalised.

Our members operate across multiple jurisdictions, and the larger international firms responsible for much of the liquidity within the EU's capital markets also own or are part of significant operations outside the EU. These firms have to satisfy the supervisors in all the jurisdictions they operate in not just those of the European Union. While we recognise that CP09 goes some way to addressing supervisory co-operation across the EU we consider it essential that the EU take account of its relationship with non-EU countries for it to achieve its greatest potential as a single market. Firms ask that CEBS focus on regulatory relationships with third countries and seek to adopt in as pragmatic and as practical manner as possible, the collaborative and cooperative approach that informs relationships within the EU. Only through engaging with key non-EU regulators can CEBS hope to promote a consistency in implementation that would be meaningful for internationally active firms.

We consider that the timing of the consultation is unfortunate. As the document notes, the CRD is only just being finalised, and some of the guidance presented will need amending to reflect changes. We would also note that since the publication of CP10 in Europe, Basel has published two important papers on LGD and Low Default Portfolios and we consider that it is essential that the paper should be updated to reflect this international 'common understanding'. This situation is further complicated by the recognition in 2.2.6 that some countries have already introduced arrangements under which preliminary applications can be made. In many cases, these arrangements have been subject to extensive consultation by national authorities and where the proposals represent significant alterations to preliminary rule sets, CP10 risks reopening the debate on closed issues. In relation to operational risk there is also little time for material on implementation to be fed into guidelines for those applying for AMA approval before firms have to finalise these applications assuming an implementation start date. We would, therefore seek confirmation from CEBS and national supervisors that firms would not be expected to resubmit entirely new applications.

On the whole, we find the level of detail and prescription in the paper excessive. We do not believe detailed guidance is helpful at this stage of firms' implementation plans. In particular, the sections on "Approval and post-approval process", "Role of the management body" "Role of internal audit" and independence of review process are all considered to be overly-prescriptive. We also find areas of the operational risk section overly detailed. We believe that the guidance should stay closer to the spirit and letter of the Directive by enunciating principles – not specific examples. There are a number of reasons why we believe this is more appropriate. One is that principles will tend to encourage rather than stifle development. This is particularly true of the AMA, when we are at precisely the point when creativity is important, for the health, not only of individual institutions, but also the operational risk management discipline more broadly. More detail on these issues is contained in the relevant sections of Appendix 2.

Related to the issues of timing and level of detail is the issue of regulatory resource needed to implement the guidance. This is an issue for both credit and operational risk where considerable resource will be needed for IRB and AMA supervision, without which the prospect of a level playing field will be difficult to achieve.

We agree that consistency in implementation, validation, and assessment standards for both the AMA and IRB approaches is desirable over time; however, we consider that it is vital that CEBS and national authorities take an evolutionary approach to implementation. This is important because this guidance has been issued so far into the implementation phase. Firms have already done a significant amount of work toward implementation and there is a substantial amount of work to do. This is complicated by the fact that the framework is still being finalised at both the Basel and the EU levels. It is therefore unreasonable to expect firms to accommodate additional guidance published at this stage. Additionally, in certain areas, such as operational risk, it would be wrong to assume that some form of convergence of models is necessarily desirable. Operational risk has itself evolved and it is likely to do so in the future. Supervisors need to be aware of this and focus their implementation effort on the appropriateness of a particular model to the risks run by that firm. An evolutionary approach also corresponds to a distinction between minimum practice and best practice. In the current phase of evolution of operational risk management industry may recognise a number of activities set out in CP10 as best practice. We believe that the proper regulatory focus, at this stage, should be on minimum practice.

The next sections provide answers to your questions and a detailed analysis of the paper, paragraph by paragraph. We would be happy to answer any questions you may have on the key messages above or on the detailed content and look forward to working with CEBS in finalising these proposals. If you would like to discuss any of the aspects of this letter please contact Ed Duncan (eduncan@isda.org), Diane Hilleard (diane.hilleard@liba.org.uk), and/or Simon Hills (simon.hills@bba.org.uk).

Yours faithfully,

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Appendix 1 - CEBS' CP10 Questions

1. Do you think that the proposed guidelines will enhance a regulatory level playing field for EU institutions using an AMA or IRB approach?

As outlined above, we recommend that CEBS clearly state the objectives of the paper and the expectation of CEBS with regard to the implementation in national regulatory frameworks once its contents have been finalised. It is unclear whether the guidelines will enhance a regulatory level playing field for our members. Clear objectives are essential for the development of a level playing field.

Our members believe that the best way for CEBS to promote a level playing field at this stage is to outline core principles for regulators to follow on both implementation and validation (perhaps in line with the principles published by the Accord Implementation Group), rather than take the very prescriptive and detailed approach taken in a number of areas of the CP. We believe a principles based approach would be appropriate for several reasons. Firstly, Basel 2 and the CRD are intended as frameworks within which firms demonstrate compliance rather than providing detailed guidance with which firms comply. Secondly, a principles based approach is more flexible to allow, rather than stifle developments in risk management. This is particularly important for areas such as operational risk, where the paper acknowledges that significant components of the risk measurement system are still evolving. Furthermore, detail designed to deliver consistent models may not necessarily be desirable. This is particularly true for operational risk, where the risk itself is evolving and where we consider that supervisors' focus should be on assessing the appropriateness of the particular model chosen for the firm and the risk that it is running. We acknowledge that achieving consistency in regulatory regimes is desirable but this may take time., Given the different stages that have been reached by both firms and supervisors and given the significant amount of work on implementation that has already been completed and how much there is still do, we recommend an "evolutionary approach" to the guidance.

Understandably, given CEBS' remit, the CP has focussed purely on achieving EU convergence. However many of our Members are internationally active EU institutions that need to satisfy supervisors in all the jurisdictions in which they operate in, not just those members of the European Union. Therefore the guidelines can only ever achieve limited success in enhancing a level playing field without further co-operation and co-ordination with supervisors outside the EU. We therefore encourage CEBS to engage with those key non-EU regulators to promote consistency in implementation that would be meaningful on a much wider scale.

We believe that the supervisory work submitted as part of the Supervisory Disclosure Framework (outlined in CP05) will be crucial to CEBS attempts to enhance a regulatory level playing field in the likely interpretations of the AMA and IRB approaches throughout Europe. We are therefore surprised that CP10 does not provide any cross references to this work stream. We would like CEBS to be clearer as to how they see the two frameworks interacting. Will the national guidance submitted as part of the Supervisory Disclosure Framework be used to highlight areas of inconsistencies between supervisors in the implementation of the final provisions in CP10.

However, we consider that, at a high level, the section on AMA (Section 4) is generally well structured and a fair representation of the challenge facing industry and supervisors in establishing a mutual understanding of the appropriate functioning of the rules on operational risk. Given the flexibility of the rules on calculating operational risk capital, such an exercise is, a priori, helpful.

2. Do you support the proposed procedures for cooperation between supervisory authorities in the pre application, approval, and post approval period, and do these procedures address the need for efficiency, consistency and reduced administrative burden for institutions applying for an AMA or IRB approach?

On the whole, we find the level of detail and prescription in the proposed procedures excessive. We support the objective to "streamline the application and decision process", and believe in an agreed minimum set of documents to be included in the application process. However we have some doubts as to whether the draft proposals will achieve either of these goals. We do not believe detailed guidance is helpful at this stage of firms' implementation plans. We would also note that much of the "guidance" reads like "rules" and would encourage CEBS to distinguish between recommendations and suggestions for supervisors to follow ("may", "could") and hard and fast rules ("must", "should") for the industry to comply with. Indeed, explicitly allowing each authority the right to require additional application documents, immediately defeats the purpose of an agreed minimum set. Supervisors should be asked to justify why additional documentation can be requested from firms.

In particular, the sections on "Approval and post-approval process" are all considered to be over-prescriptive. These sections are discussed in further detail in the Appendix, along with similar concerns around the sections covering the "Role of the management body" "Role of internal audit" and independence of review process.

The proposals should be read alongside the proposals in the CP09 Home Host paper from CEBS. CEBS should ensure consistency between the relevant CEBS papers in this area to avoid unnecessary overlap and/or confusion.

The CP in certain areas appears to 'gold plate' the requirements of the CRD. Additionally, CP10 allows regulators at a national level to impose additional stricter requirements. Given the proposals contained within the EU Commission's Green Paper on Financial Services Policy (2005-2010) we do not consider this approach appropriate. We urge CEBS to focus agreement on a common understanding of the minimum requirements for implementation.

3. Do you think that the areas covered in the guidelines represent a significant and for your purposes useful convergence among supervisors? In which precise areas would this be true?
And
4. Has CEBS focused on the areas of greatest relevance to the industry?

It is unclear to the industry how the work of CEBS is being prioritised and therefore how the content of CP10 was arrived at. Although the proposals cover some key areas of implementation on both the AMA and IRB approaches, there are some significant topics that have not yet been addressed (e.g. Securitisation, Exposure at Default). The industry would like clarity on if, when and by whom these areas will be addressed and would like to reiterate their concern over any new guidance coinciding with firms' implementation plans already in place. Given the lack of prioritising or emphasis of key CEBS guidelines within the paper it is hard for our members to identify key themes or messages. The objectives of the paper are obscure and the volume of material provided is considerable. Consequently we would find it useful if the material were ranked in importance in some way. Perhaps the “Executive Summary” could highlight the guidelines which CEBS sees as being most important.

The quality of the drafting of CP10 could be improved. Parts of CP10 do not appear to add to the legal minimum requirements set out in the CRD, for example, in paragraph 54, the minimum requirements of the Directive are reproduced as a list in the CEBS document. As a result, it is unclear to the industry what the purposes of some of the sections are. This repetition would become clearer and more obvious if CEBS were to make more use of direct references to specific Directive text. Should CEBS intend only to duplicate the requirements set out in the Directive we would urge them to avoid confusion by using exactly the same wording and format. Any slight difference could lead to supervisors and/or firms misunderstanding the intentions of CEBS. Apart from restating large “chunks” of the requirements set out in the Directive text, our members feel that where new, additional guidance has been added, its context and meaning are confusing. A clear example of this is in the section on Loss Given Default where definitions are less than clear (e.g. “realised LGDs”), and where the guidance on methodologies is considered unhelpful (particularly including references to pooled LGDs and the use of averages, see points raised in the detail in appendix 2).

Finally, there are a number of points where we believe the CP to have carried the treatment of operational risk into territory that is too prescriptive. Perhaps the most significant of these concerns the Use Test. We are comfortable with the higher level principles (1 through 4) laid out after paragraph 437, but do not believe it necessary or wise to include the examples. Among these, we would direct the most questions to the second ‘example’ under principle 2 (on the responsiveness of the risk measurement system) and the first under principle 4 (on senior management action). Both these implicitly carry the dialogue between supervisor and supervised into a level of granularity that would cause considerable work but, arguably, without ever being able to meaningfully satisfy the requirement[1]. Overall, however, we stress our view that all of the text after paragraph 437 should be restricted to principles that appear in bold in the text of CP10 (subject to some suggested amendments).

5. What other areas of importance should be covered by CEBS in possible future work on AMA and IRB approaches?

Any further work should be clearly focussed on specific topics or concerns and each paper should have a clear objective and rationale. The papers should provide explicit principles rather than just elaboration on the Directive requirements and aim to add to firms’ and supervisors’ understanding of issues. However, having said that, the industry is not currently looking to CEBS for further guidance. Many of our members feel that areas that have yet to be addressed, such as securitisation, EAD, and the trading book may not require any additional level of guidance.

[1] The Use Test has been the subject of considerable discussion in national implementation debates between industry and regulators. This has for example included discussions in the UK, where industry believes that the final form of the Use Test document published on the FSA web-site is instructive in terms of the level at which the guidance is set. The link to the paper is: http://www.fsa.gov.uk/pubs/international/orsg_use_test.pdf

Appendix 2 – Detailed Comments

Co operation procedures, approval and post approval process (Section 2)

- Para 29: It is not clear to our members what the implications of the last sentence are ("It may therefore be necessary to determine in each case which rules exactly apply for the retail exposure class.").
- Para 35: We feel that CEBS may have missed an opportunity here to streamline the application and decision process by not including a formal requirement for supervisors to communicate the outcome of relevant "exploratory" discussions about the use of internal models.
- Para 38: All of the bullets here except one refer to what supervisors are expected to do in the pre-application period. The fourth bullet point refers to where the "group" needs to familiarise itself with the approval framework and the requirements and standards concerning the information that it will need to submit. It may be better to include this point somewhere else, with a section on what firms need to do and one on what supervisors are expected to do (e.g. this bullet point could be moved to Section 2.2.1 "Application"). We would also like to point out that there is no reference here to the situation where the consolidated supervisor comes from outside the EU.
- Para 39: The language in this paragraph leaves the roles and responsibilities of the home and host supervisors in Europe very open and our members would like CEBS to provide more clarity over which supervisor is going to do what in relation to the IRB approach. At a minimum we would like to see a reference to the relevant sections of CP09 "Guidelines for cooperation between consolidating supervisors and host supervisors".
- CEBS CP10 identifies a pre-application period, which most firms will already be involved in, but the CP fails to attach enough importance to this process and often seems to suggest that the process and all the work involved will need to be repeated.
- Para 40: In general we feel that CP10 lacks a clear statement on the appropriate division of responsibility and here, it's not clear why the section on "host branch" responsibility is singled out, while responsibilities of a subsidiary are not referred to.

Documentation of Rating Systems

- Para 50 & 56: These paragraphs are clearly related as Para 56 provides for a definition of terms used in Para 50, CEBS should therefore consider re-drafting the requirements together or in some other way linking them both together.
- Para 57: It is not clear what is meant in the third bullet point by "For IRB, the organisation of rating assignment". We also question the need in the fifth bullet point to have a separate overview of the validation process. We believe that this is more than adequately covered in the IRB and AMA sections of the paper.

Implementation Plan and Self Assessment

- Para 58: We do not believe that the implementation plans should be "binding". Instead we believe that flexibility is required since projects on such a large scale very rarely proceed entirely according to plan and there will be need to reflect ongoing discussions with supervisors regarding the state of firms' implementation plans. We would like CEBS to recognise that both implementation plans and ratings systems are likely to evolve over time.

- Para 59: We believe that the level of detail and the style of language here (e.g. “must” and “laid down”) is inappropriate. We would question the level of the breakdown and whether details of firms’ staff training is a useful part of the implementation plan. The breakdown should be by whatever makes the greatest sense in terms of describing the implementation plan. For example, a breakdown by supervisory asset class is unlikely to be helpful to either prepare or rely upon. We also consider it a bit late in the day to be including a “preparation of the technical concept for IT implementation of the rating methodology”.
- Para 60: It is not clear to us how “gross credit volume” differs from “credit aggregates in the exposure value” or what is meant by “risk content”.
- Para 63 & 64: Here, we feel too much detail has been provided and that these two paragraphs should be removed. However, if CEBS chooses to ignore this advice, we would question in Para 64 the emphasis on the self assessment being conducted by “an independent risk assessment function”. We would also ask CEBS to soften the language in these two paragraphs to better reflect the status and intention of the guidance (use of the word “should” implies an order or something that is inevitable).
- Para 70: We welcome the recognition that the “six month clock” may be paused under certain circumstances.

Supervisor’s Assessment

- Paras 72 to 79 (and Para 97): We think that there needs to be more recognition by CEBS of the informal work already underway in relation to the application process (e.g. UK FSA “shadow” application process). Given the amount of work that needs to be done on the part of supervisors and firms to meet CEBS requirements, it has not been possible to wait for the final CRD text to become available, and as a result many firms and regulators will simply seek to update their application work rather than submit and review brand new documents. We would point to the language in Para 97 as being more helpful than that of the earlier paragraphs.

Section 3: Supervisor’s assessment of the application concerning the minimum requirements of the CRD – Credit Risk

Roll-out

We find section 3.1.1different to the majority of the other sections in the paper in that it presents the choices available to national supervisors as opposed to prescribing a specific approach. The challenge of presenting more detail around the CRD text, while maintaining a flexible approach is that what is left is non-mandatory and contains so many choices that it fails to achieve any more consistency than the CRD text would achieve on its own. An example of this is paragraph 101 which attempts to deliver further detail around Art. 89 of the Directive, but recognises that supervisors will apply different approaches to the roll-out, therefore undermining one of the key goals of CEBS as stated in Paragraph 14 “to reduce inconsistency in implementation and supervisory practices”. Although we support a flexible approach, a simple requirement to have a roll-out plan and to agree this with the supervisor is all that is necessary here.

- Para 101: This paragraph recognises that supervisors are likely to apply different approaches to the "roll-out" and therefore we believe undermines one of the key objectives of CEBS stated in Paragraph 14 "to reduce inconsistency in implementation and supervisory practices".
- Para 103: Outlines further detail around the time horizon for firms roll-out plans ("short enough to avoid…" and "long enough to ensure…"), and yet in recognising the need to be flexible, rules out anything that might achieve further consistency.
- Para 104: It is unclear what is meant by the "sequence of exposure classes" in the roll out of the IRB approach.
- Para 106: Here, CEBS recognises that it is the firms' responsibility to meet the "minimum requirements", but our members are still unclear as to what those minimum requirements are. This could be made clearer by including a reference to the minimum requirements set out in the CRD (Annex VII – Part 4 for IRB credit risk and Annex VIII – Part 2 for CRM).
- Para 107: In stating that some supervisors may introduce "supplementary binding milestones during the roll-out period" and in proposing three loosely defined options for supervisors to choose from in order to assess whether minimum standards are being met, CEBS has fallen along way short of achieving consistency in implementation of roll-out plans across the EU.

Permanent Partial Use

In this section we note that CEBS has not provided for an EU definition of materiality. We would like CEBS to include a presumption that the consolidated supervisors' definition of materiality will be the one that counts.

Use Test and Scope of the Use Test

- Para 129: In the sentence beginning "While ratings and default…" there are one too many "be"s.
- Para 133: It is unclear why this paragraph and this paragraph alone embarks on a discussion employing a number of technical terms ("linear" and "homothetic function"). We recommend avoiding such terms in what is intended to be fairly high level guidance.
- Para 135: The requirements laid out in this paragraph could be made clearer. Where it states that firms report "total capital requirements" before being granted permission to use IRB, CEBS should state whether they would expect this to include Pillar 2 charges or not. The last sentence is also unclear.
- Para 137: There needs to be some recognition here that all parameters are not born equal, e.g. EAD is less well defined and more difficult to validate than other parameters.
- Para 138: We believe that this could state more clearly that parameter estimates used for Basel II regulatory capital calculations do not necessarily have to be used elsewhere within the firm.
- Para 140, 139 (& 129): Paragraph 140 is not clear and seems to contradict previous paragraphs. In earlier paragraphs there are references to possible "differences" in ratings and estimates used for internal purposes, however paragraph 140 then talks about the final parameters being "strictly in line". We would urge CEBS to make these minimum requirements around the use test, scope and data more explicit. In

particular we would like to see a clear statement that in some circumstances internal estimates are likely to, and can differ from those being used for regulatory purposes.
- Para 141: We wondered whether firms would always be in a position to rely on the financial statements when rating a corporate, and whether this requirement would be better phrased as guidance rather than a rule. In corporate "start up" cases, it is very unlikely that financial statements would be available for rating purposes.

Methodology and documentation – Retail Exposures

- Para 151: We would like CEBS to include reference here to the "reasonable steps" language of Article 86 (Para 4(a)), and thereby ensure consistency with the minimum requirements as set out in the Directive.
- Para 154 & 156: We believe these paragraphs contain useful concepts, and we support both the idea of "temporary" violations and appreciate the realism in Para 156. However, we would suggest removing the second bullet point that requires firms to quiz their clients about the size of other exposures held, as we consider it to be impractical for large international firms due to the large number of clients.
- Para 155: This does not reflect the most recent amendments to the Directive which excludes residential mortgages from the aggregation requirement.
- Para 157: We believe that this Paragraph should refer to exposures in general, rather than limit the scope just to "loans".
- Para 158: This is an example of where we think there is too much detail. The situation described here, in the case of information passed from parent to subsidiary, is likely to vary from one case to the next, and as such it is unclear what value further guidance will add.
- Para 167: We are not clear as to what "volatility" is being talked about here, and we think that this could be made more explicit. The CRD does not require comparison with a firm's other retail asset classes. We would also recommend replacing "any time on request" with "at least annually".
- Para 168: As the QRRE is a new qualifying asset class within the CRD we do not feel it appropriate to mandate an approach to determining volatility and providing data in particular for the other retail portfolios which is beyond the requirements within the CRD. We think that the definition is too prescriptive and would appear to prevent firms which do not have loans in the other categories from qualification. Whilst this could be an approach firms look to take, firms need the flexibility to make a determination of the volatility through other approaches, subject to the satisfaction of the supervisor.
- Para 169: We would ask CEBS to review the last sentence, as its meaning could be made clearer (if no collateral has been assigned, how can collateral value be included in the LGD estimate).

Methodology and documentation – Corporate Exposures

- Para 171: This could be drafted more carefully as the current wording is a bit clumsy. We might object to the inclusion of a requirement to provide yet further evidence of conservatism, as this implies that a firm electing to substitute assets for sales on a voluntary basis (believing them to be a more meaningful measure) would have to maintain estimates based on both, in order to provide the relevant evidence of conservatism.

- Para 179: This is an example of where we would like CEBS to reference the relevant national discretion item (including CRD reference). Also, as HVCRE is no longer referred to in the CRD we believe the last two sentences should be removed.

Definition of loss and default

- Para 191: This paragraph is unclear and we believe confuses risk quantification and rating assignment.
- Para 195: We would observe that since CEBS has not defined the materiality threshold and that as this is going to be defined differently across EU member states, the “minimum criterion” referred to here is unlikely to prevail.
- Para 199-200: The definition of realised loss and loss in LGD is unclear and not obviously consistent with paragraph 168
- Para 203: We felt that the language here was confusing and that there was no clear distinction made between “realised LGDs” and “estimated LGDs”. Clarity is essential given concerns about data capture in relation to the discount rate for “realised LGDs”. CEBS makes no reference in the guidance to practical issues such as the extent to which firms have adequate data on the timings of recovery cash flows, whether firms have the ability to derive discount rates from external data used, and more generally about the quality of data captured. We urge CEBS to be as flexible as possible in this area to allow firms to develop and evolve suitable methodologies to address these issues.
- Para 205: This does not acknowledge or accommodate operating models where costs are held centrally rather than being allocated back to each “defaulted exposure” or “pool”, and we do not want to be required to introduce cost allocation that is for good reason not part of the normal business/risk model. We would also observe that indirect costs are not always included in the economic cost of a loan (e.g. if you wanted to sell the loan, a fair value may not include these types of costs). Finally, our members wondered whether, if firms can evidence that all costs of the work out are included, “an appropriate percentage” could be zero so long as firms were able to justify this.
- Para 206: We notice here that CEBS introduces another concept of materiality (in the allocation of costs) that firms are expected to define and document, without providing further guidance on what might be considered acceptable/unacceptable or how this definition of materiality might interact with others required.
- Para 205–206: We are also concerned about the inclusion of “indirect” costs in the calculation and the requirement to allocate corporate overheads at infinite levels of granularity. We recommend CEBS allow for a broader assessment of what costs would be considered relevant.

  Consider a corporate overhead such as the specific cost of a CEO. Para 205 requires that an appropriate percentage of the cost should be taken into account. However, under Para 206, a bank has the option to exclude a percentage of the cost on the basis that it is not material. This should make the process manageable. However, the requirement in Para 206 to document individual cost elements, and the aggregate cost means that the process is still an onerous one. The materiality clause in Para 206 will only be of real benefit if firms are only required to calculate cost elements considered relevant. In conclusion, we strongly suggest that CEBS do not specify that costs should be allocated as part of the LGD estimate when those costs would be incurred irrespective of whether there was a work-out.

- Para 209: We would like to see more focus here on expert judgment systems which use judgment to arrive at credit assessments using both qualitative and quantitative data.
- Para 211: Some of our members have suggested that the third bullet point could be difficult to comply with as firms may not have all the relevant information.
- Para 213: It is not clear to us what the middle section of this paragraph means and in particular, that when using direct estimation methods "all of the requirements for the rating assignment methodology apply to PD estimation as well".

Rating systems and risk quantification – PD and LGD

- Para 217: The definition of realised LGDs here is not a good one. The requirement to record realised LGDs at "as granular level as possible" is onerous and does not reflect legal requirements in some jurisdictions, where it is generally more appropriate to record loss at the level of the operation. Here the calculation of realised LGD is likely to occur at the level of the analysis not at the data collection level.
- Para 218: CEBS provides a step by step overview of what LGD estimates must be based on, including economic downturns, long run default weighted average estimates and long run forward looking recovery rates. However, the guidance remains unclear on the relative importance of each of these concepts and how they are likely to interact. We would like to suggest that where a downturn estimate is relevant and is the appropriate estimate to use, appropriate adjustment will be made to the forward looking estimates. This paragraph seems to allow for firms to "adjust either the measurement of the realised LGD or the estimation of the final LGD". This may have resulted from the earlier confusion over the distinction between the two concepts, but we believe that only adjustments to estimates make sense, as observed losses should be what they are, namely observed, and not altered.
- Para 219: We think that this paragraph may need updating following the publication of the Basel guidance on the estimation of LGD. We suggest that CEBS does not seek to duplicate CRD text, if this is a repeat of the Basel framework Para. 471 requirements.
- Para 220: We question the consequences of the first statement as described, "That institutions cannot rely on industry-wide estimates without adjusting them to reflect their own position". This implies that there is no room for firms to justify that no adjustment is appropriate.
- Para 222-225: Here CEBS lays out the detailed requirements for the Reference Data Set (RDS), including the need for this to be updated "when necessary" (Para 224). As written, this suggests that firms should change their base historical data set to reflect changing circumstances. In reality if the data set shows an experience which is no longer representative of the future outlook, then firms are more likely to make an adjustment as part of the modelling process rather than through changes to the original data. We recommend that the requirements for the RDS reflect that changes should be made to the data set used for modelling LGD (the accredited loss history), and not the actual historical baseline data.
- Para 225: We welcome the flexibility for the treatment of "cures" provided here in the guidance, as our members support both the inclusion and exclusion of cures, providing that firms are able to justify the approach and adjust for an appropriate level of conservatism.

- Para 225: We would like to see reference made here to collateralised exposures, and in particular derivative positions where often the exposure is over-collateralised.
- Para 225: The definition of default is provided for in the Directive, it is therefore not possible to use an “inappropriately early definition of default”.
- Para 226-227: In general, we support the flexible framework proposed by CEBS whereby firms are encouraged to adopt and justify the most appropriate risk drivers given the legal, macro-economic and firm specific criteria for that portfolio, asset class or jurisdiction. We would not support any requirement to justify the irrelevance of drivers not considered by firms as part of their assessment, as long as firms evidence and explain to the satisfaction of the supervisor that relevant drivers have been used. A mandated framework of application across the EU is not felt appropriate and we welcome the approach taken by CEBS in Para 227. On a technical drafting note, as “Other risk factors” is a specific category under Para 226, it makes no sense for Para 227 to say that Para 226 is not comprehensive, and for additional provision to be made requesting firms to investigate “additional risk factors”.
- Para 228: We recognise that this paragraph reflects the requirements laid out in the CRD in not permitting estimates based purely on judgemental considerations. However, we would discourage CEBS from introducing requirements which may restrict developments in business or risk management, particularly in the area of new products and/or client types and the use and availability of external data and other external proxies. These are typically areas where firms would expect to be allowed to use a significant amount of expert judgement, and we would look to the regulatory work on low default portfolios to gain some comfort (both in the principles published by the AIG and in the work of the UK FSA Expert Group on low default portfolios).
- Para 230: It is not clear what is meant by “appropriate adjustments” and greater clarity from CEBS would be helpful.
- Para 231–233: We do not agree with the proposed requirement for firms to include incomplete workout cases in estimates of LGD. Inclusion of the results of incomplete workouts into LGD estimates will result in LGD estimates based on loss estimates, rather than true observed losses. If the LGD estimate is based on the average of realised LGDs for a certain group of exposures, which our members believe is the intent, incomplete workouts cannot be incorporated into the calculation since they do not have an associated realised LGD. The requirement to include incomplete workouts is especially inappropriate for corporate exposures, or workouts with binary payments, e.g., the liquidation of mortgage loans. We suggest that rather than include incomplete cases, it is logical and desirable for firms to monitor incomplete cases carefully to make sure that LGD estimates based on complete cases remain consistent with any trends seen in ‘live collection cases’. As such, firms should retain the flexibility to choose what data is included at what stage in the estimation of LGD, as long as they can justify that the LGD is not underestimated. The last statement in the second bullet point of Para 233 is also unclear: "If institutions are using recovery rates not higher than the already collected recoveries, then the estimated LGD will be based on a measure of average realised LGDs".
- Para 234: The statement about the use of “direct estimates” and derivation of “quantitative estimates” is unclear. It is also unclear from this paragraph what the expectations and requirements are for both “pooled” estimates and the averages of “individual direct estimates”.

- Para 235: Unfortunately we did not find the guidance for the “two-step procedure” very helpful. Some of our members found the distinction between the borrower grade and facility grade largely confusing and potentially inaccurate.
- Para 236: There has been some confusion amongst our members as to the intent and meaning of “Current market prices of collateral on current exposures will influence their estimated LGD”. We would be concerned how this might be interpreted locally as rules or guidance if the current drafting is maintained. We would therefore ask CEBS to reconsider the wording in order to achieve greater clarity and give better direction to both firms and supervisors.
- Para 237: This paragraph seems to imply a hierarchy of regulatory preferences, with “implied market LGDs” being less favoured (with methods using internal data most favoured). We are concerned that under certain circumstances, perhaps where internal data is scarce, supervisors mandate the use of information such as market prices that may not be relevant. There are no firms currently using “implied market LGDs”, and we would therefore like to see CEBS acknowledge this by including reference to a risk management technique available now that may evolve over time.

Rating systems and risk quantification - Conversion Factors (Exposure at Default or “EAD”)

Once again, we feel that the whole section on Conversion Factor (CF) modelling is too prescriptive, with CEBS seeking to provide too much detail on definitions, time horizons, data, and risk drivers. Given that less is known about EAD values and validation, it is the least understood parameter, we would expect CEBS to incorporate flexibility through the provision of high level guidance and not detailed rules.

- Para 245: The modelling referred to here is very restrictive. This approach, although common, is questionable and is not always appropriate, e.g. it is not suitable for “aval” lines (contingent liabilities such as performance bonds, bid bonds & guarantees), where the outstanding is always zero even though a commitment for a (conditional) payment (not necessarily identical to a limit) may have been may made. EAD modelling for these products can not follow the common CF approach.
- Para 247: The "momentum approach" (to calibrating CF) is only mentioned here and then defined later in Para 253, we would recommend linking these two paragraphs in some way.
- Para 253: We believe that favouring the fixed horizon approach over the cohort approach (to calibrating CF) is setting a wrong incentive as the latter does not restrict the information employed.

Quality of internal documentation

- Para 271: We are concerned that it may be very difficult for a third party to “replicate all or part of the institution‘s validation” or indeed “fully understand the reasoning and procedures underlying the development and validation” of a firm’s rating system. As a minimum requirement the suggested guidance would be very difficult for a firm to prepare to comply with.
- Para 273: Elements of this paragraph refer to the minimum requirements for validation and not “Quality of internal documentation”, we would suggest for clarity sake removing the first two sentences.

- Para 277: We believe that these requirements could be misinterpreted as the scope is unclear. The text appears to refer only to ratings but may be read to be required for LGD/CF calibrations/modelling. What are the real requirements here?

External Vendor models

In general, we fear that the requirements for the use of external models are too onerous. We do not believe that vendor models can fulfil all the same requirements as internal models. We would like CEBS to recognise that vendors are likely to have to restrict what information can be shared with firms regarding their models, especially for smaller firms. Therefore we would suggest that vendors be allowed to approach supervisors directly where they believe evidence required is confidential/propriety.

Data

- CP10, as with a number of other proposals set forth in CEBS consultation papers, refers to data requirements in a number of different places. We find this dispersion of information unhelpful, and wondered whether CEBS might consider centralising proposals on all aspects of data.
- Para 303: This states that "Internal Audit of data quality should include at least the following: an annual review of controls,…", which we believe should be changed to "a regular review of controls". (See further comments below on Internal Audit)
- Para 308: Some of the language employed by CEBS is not consistent with language intended to be guidance, and therefore not considered to be helpful. For example, "The following types of documentation are <u>essential</u>*:*"
- Para 311: We consider the multiple references to "conservatism" unhelpful and we would prefer to see a more realistic and pragmatic approach based on maximising the use of the data available.
- Para 312: It is impractical to expect every single driver ("all key characteristics...that could relate to default…or loss") to be representative in a development or test sample as deviation is natural and vital for establishing appropriate quality in the prognoses.
- Para 313: The second bullet point is unclear – what is the requirement here? We also note that the last bullet point is a little confusing, as we were under the impression that the definitions that are required to be used were provided in the CRD, and "deviations" were not permitted.
- Para 315: We think the drafting could be improved to better express what CEBS had in mind. Data history requirements for each of the parameters are laid out in the CRD, with specific minimum requirements for the number of years of coverage. Estimates are also required to be forward looking, however Para 315 does not provide any insight into how this is supposed to be achieved.

Validation – quantitative and qualitative assessment

We strongly believe that the best way to achieve some form of "common understanding" on validation is to identify core principles, along the lines of those published by the AIG, for supervisors and firms to follow. As such we believe that the more detailed guidance in CP10 should be removed.

- Para 321: We are unclear as to how the second half of this paragraph (after "Thus") relates to the first half. We would also question what it adds to the CRD text – it may be possible to remove it altogether.
- Para 324-325: Under "Principle 1", the distinction between "risk estimates" and "ratings" is unclear.
- Para 326-327: Our members feel that these paragraphs go into too much detail. We believe that a firm's analysis is likely to use qualitative factors that are "point-in-time" (e.g. a share price might be considered "point-in-time", as the only share price that matters is the share price now) combined with expectations for the future and is therefore neither "point-in-time" or "through the cycle". As such ratings are generally forward looking and based on all relevant available information. Assessment horizons and historical data pools vary across ratings, and appropriate controls, documentation and senior management oversight ensure that firms take account of all the relevant inputs. Models are a product of their times and it is important that CEBS provide guidance in such a way as to ensure the continuing evolution of risk management practice. We believe that for CEBS this means putting in place a broad framework that does not specify "a philosophy of rating" or require firms to identify one. Ratings systems are evolving beyond the terms "point-in-time" and "through the cycle". The range of practice in place demands flexibility from the supervisors, particularly where rules become embedded into the law of a country.
- Para 329: We are not sure what is meant in the fourth bullet point by "more stable estimates". Furthermore, the last bullet point states that in assessing the performance of a rating system institutions should have policies covering what "action should be taken when acceptable levels are breached". However, we would like to point out that firms ratings' will often target longer-term performance, such that it may not be appropriate to take any action due to a breach in performance over the short-term (thus, "no action taken" should be an acceptable policy).
- Para 337: We are unclear as to what "a higher margin of conservatism" means in the following extract "In cases where a lack of internal or external data prevents the proper use of <benchmarking and/or back testing>, institutions should apply a higher margin of conservatism in their estimations". How is this to be measured?
- Para 341 – 344: We think that the requirements to benchmark against external data are super equivalent to the CRD. These requirements are unachievable for many portfolios and more so for LGD and CF estimates. The points listed in Para 344 will be very difficult for firms to obtain for external data.
- Para 352: "Limitations in the dataset" will always call into question the value of performing quantitative validation techniques for Low Default Portfolios. The following two paragraphs (353-354) seem to shed a little more light on the problem, but do not exclusively refer to "Quantitative Validation", so we would therefore suggest amending this paragraph and reviewing the title for this section.

Internal governance

Sections 3.6.1 and 4.3.5 (paragraphs 365 to 370 and 469 to 476 respectively) on Internal Governance impose specific, prescriptive obligations on banks' supervisory bodies and senior management in relation to Credit and Operational Risk (OR) (see section 4 below). For example, banks' supervisory bodies are made responsible, together with senior management, for the approval of: all material aspects of the risk management framework (e.g., all activities aimed at identifying, measuring, monitoring, controlling, and mitigating OR); specific levels of acceptable risk; pro-active risk management strategies and policies;

the project goals, implementation structures, time to completion, costs and benefits; and overseeing Risk Control, OR and ORM on an ongoing basis. Furthermore, firms' senior management are required, for instance, to: have "extensive" understanding of credit & operational risk policies and risks; ensure that all components of the IRB system, including controls, are functioning as intended; define the content of IRB and OR reporting to the supervisory body / delegated bodies; take responsibility for ensuring that before new products, activities, processes and systems are introduced, the OR is subject to adequate assessment; monitor and manage all sources of potential conflicts of interest; and ensure all the staff are aware of the relevant policies and procedures.

These prescriptive requirements could mean that, for example, institutions will need to substantially modify board level and senior management committee terms of reference and then spend valuable board and senior management time on issues which could be successfully dealt with either through delegation or at lower organisational level. We do not believe that the CRD text intended for this to happen, and we would therefore recommend that CEBS drop the prescriptive requirements for firms' corporate governance bodies and senior management. Instead we recommend that CEBS provide some high level guidance along the lines of:

"CEBS requires institutions to assess the matters which are relevant to them in successfully governing and managing Credit and Operational Risk and to assign responsibilities to their governing bodies and senior management. CEBS expects an institution to be able to explain and justify its approach to Credit and Operational governance and management when subject to external review."

Our members believe that the sections covering Internal Audit as well as references to Internal Audit or "independent review" throughout CP10 are overly prescriptive. It is not clear why CEBS has decided to increase the level of requirements in this area from the Basel principles and the provisions of the CRD. We propose, CEBS drops any rules/guidance over and above that which exists already in these texts.

We also have the following detailed observations:

- Para 334, 364, and 376: We are concerned that the required measure of independence for the review function goes beyond that intended by the CRD, for example where Para 334 states that "A credit institution's validation processes and results should be reviewed for integrity by parties within its organisation that are independent of those accountable for the design and implementation of the validation process". CEBS goes further in asking for a split between an institution's Credit Risk Control Unit and Credit Risk Control function. Even for large institutions, where skilled resources are in short supply, such levels of independence represent a significant challenge.
- Para 363: Our members strongly support the guidance outlined here, and the idea that model review and model development and selection can be carried out by the same team.
- Para 369: We would discourage CEBS from providing this level of detail. Attempting to define what a "management body" is for large diversified banking groups across the EU runs the risk of creating a work stream that could go well beyond the scope and timeframe of implementing the CRD.

- Para 377: We believe that the requirement to report CRCU review results to the “management body…at least twice annually” may go beyond the requirements of the CRD. In practice this may occur more frequently, but we would not expect to see guidance from CEBS on this.

- Para 385: The proposal in the second bullet point to require that “the head of the control function should be subordinated to a person who has no responsibility for the activities that are being monitored and controlled”, technically implies that the risk methodology and validation units may not be a part of the same risk management function. This would go against common practice in many institutions.
- Para 389: Industry members do not support the requirement for Internal Audit to test that the Credit Risk Control function’s conclusions are well-founded, nor that it should review the adequacy of IT infrastructure and data maintenance. These are areas outside the expertise of Internal Audit and would best be addressed by other internal bodies with appropriate knowledge but who are sufficiently independent of the Credit Risk Control function.
- Para 390: We would recommend that where it states “Internal Audit will report at least annually to the management body (both supervisory and management functions) on the institutions compliance with the IRB requirements”, the wording be changed to “Internal Audit or an independent risk management function” will report regularly to the management body.

Independence/conflict of interests in rating assignment

In general, we find that this section (3.6.4) seeks to provide too much detail and is too prescriptive. Instead, we would ask CEBS to provide just a few high level principles for firms to follow.

- Para 400: We do not think it is helpful for CEBS to attempt to describe what borrower information is likely to be available to credit officers or rating committees. In practice this is likely to differ across firms and for different scenarios within firms.

Section 4: Supervisor’s assessment of the application concerning the minimum requirements of the CRD – Operational Risk

The associations consider that, at a high level, the section on AMA (Section 4) is generally well structured and a fair representation of the challenge facing industry and supervisors in establishing a mutual understanding of the appropriate functioning of the rules on operational risk. Given the flexibility of the rules on calculating operational risk capital, such an exercise is, a priori, helpful.

We do, however, have a significant and broad concern, which relates to the level of detail into which the section goes at several points, when we believe it should be staying closer to the spirit and letter of the Directive by enunciating principles – not specific examples. There are a number of reasons why we believe this is unhelpful. One is that it will tend to stifle development of AMA techniques at precisely the point when creativity is important, for the health not only of individual institutions but also the operational risk management discipline more broadly.

Our two other, overarching concerns are ones of timing and resources. The timing issue inter-relates with that of detail, since there will be very little time for material on implementation to be fed into guidelines for firms applying for AMA approval before firms have to finalise these applications, assuming they wish to use an AMA beginning in January 2008. If for only this reason, we believe it may be sensible to cut back on the amount of detail.

As regards resources, we believe that the issue should be dealt with prominently in the paper. Supervising AMAs will require considerable regulatory resources and, if these are not in place, then the 'level playing field' fails at the first test. And it will (or ought to) become quite apparent sooner or later how level the 'playing field' truly is, given that there is a reasonable expectation that national regulators will disclose how they are implementing the Directive. CEBS should stress regulators must devote adequate resources, in order for the system to be workable.

As regards level of detail, CP10 makes one significant point admirably clear (Para 449) "significant components of the operational risk measurement system are still evolving in the industry". In this context, it is especially important to ensure that neither risk management nor supervision thereof become mere check-lists, since these carry with them a triple hazard of being incomplete, inappropriate and overly prescriptive.

Philosophically, this corresponds to a distinction between minimum practice and best practice. While, in the current phase of the evolution of operational risk management, industry may recognise a number of the activities set out in CP10 as best practice, the proper focus of such a paper should be minimum practice, and we have identified many cases of what we view to be standards that go well beyond it.

We note that the capital rules for AMAs are quite deliberately structured to provide an outline for the management of operational risk, in which it is intended that firms provide not just the fine detail but the main features too. To be absolutely clear, this was no accident. It was intentional. In fact it was necessary, given the nature of operational risk models. These are – and always will be – inherently capable of varying, as between firm and over time.

So, while the phrase from paragraph 449 that we cite above (about evolution of models in the industry) is true, it is not the complete picture. Specifically, it would be wrong to assume, for example, that some form of convergence among models must happen. And it would be wrong to assume that the flexibility in the AMA rules is a function purely of the current general state of development of AMA models in the industry. Rather, it is a reflection of their fundamental nature. It also reflects the fact that operational risk itself has evolved and is likely to do so in future, taking on new forms. (An example of this in recent times has been the rise of risks associated with electronic communications.)

So, just because a certain amount of time has passed since the Basel/CRD rules were drafted, it does not mean that there is (or prospectively will be) an appropriate point at which supervisors could or should start filling in any of the main features or fine detail of how operational risk models function.

To put it another way, the AMA rules as set out in the Directive, should not be viewed as somehow 'incomplete'. And the absence of detail should not be considered to constitute an invitation for supervisors to narrow down the specification of op-risk models through the implementation process. The process of implementation should be driven by the choice of model made by a given firm, and all other more detailed questions should flow from that individual firm's choice.

Below, we devote a specific section of our response to identifying those parts of the CP where we feel it does stray into inappropriate detail and where we feel that the best solution would be to leave the high-level language in place but remove the examples that are typically enumerated in a series of bullet points. Before that section of our response, we note those paragraphs which we consider to be particularly helpful. We also include a section on paragraphs that raise other issues, apart from the question of the level of detail. Finally we include a few purely typographical comments.

Level of detail

As a general point, we believe that, unless strictly justified by the Directive text, language that potentially or actually imposes some sort of minimum practice – let alone best practice – should not be used.

The nature of the AMA means that a significant amount is left to the judgement of both individual firms and their supervisors. In this environment, any material published by a body of the formal standing of CEBS, even if it is not expressed as an explicit outright requirement, can very easily find a 'back-door' route into the operating procedures of line supervisors (and auditors). The natural presumption will be in favour of whatever CEBS produces and that is a power that should be used with care.

We recognise that CEBS can and does act as a forum in which supervisors may share views on the range and evolution of operational risk management frameworks within firms and the supervision of the same. We also appreciate the commitment to transparency that CEBS has shown in its work on operational risk in CP10. We further believe that CEBS can play a very useful role in future in pulling together (and sharing with industry) high-level or stylised information on AMA models. But the emphasis should always be on the coherence of any individual model, rather than a growing list of points against which all models are to be judged.

Please note in this regard that, while one inappropriately imposed practice may prove to be a burden, the cumulative effect of a number of inappropriately imposed practices is likely to be exponential, seriously undermining the AMA.

If, for some reason, CEBS is unable or unwilling to follow our advice in removing this more detailed material, we strongly urge the Committee to ensure that a prominent 'health warning' is introduced at the start of the section, to the effect that:

- materials provided by way of example should be treated with great care;
- examples should never be viewed as obligatory or comprehensive;
- the appropriateness of each example should be considered in the specific context of the operational risk framework of the particular institution.

Also, at each point where such detailed material is introduced, the initial 'health warning' should be referred to or its essence repeated.

By way of supporting argument for our views on the appropriate level of detail, we note the fact that the Directive itself deliberately adopts the framework-plus-annexes structure, designed to support an evolutionary set of rules. This makes it particularly invidious to push development in any particular direction, however rational that direction may appear at the time of writing. Moreover, the current CP already enunciates (in paras 482 and 486) a set of standards and organisational considerations pitched at what we do view to be an appropriate level. By contrast, anything which goes in the direction of 'painting by numbers' is not helpful, either to industry or, we would argue, to supervisors.

As a last introductory point, and on this same theme, we note that in more than one paragraph there is what appears to amount to a requirement to reconcile operational risk losses to the general ledger. If that is indeed the requirement, it is impractical and goes well beyond the requirements set out in rules documents.

In the course of implementation discussions, industry has consistently noted that, while some means of checking the integrity of operational risk loss data is clearly necessary, it is an unnecessary burden to have to pursue line-by-line reconciliation. In some instances, reconciliation may not be possible. And even if reconciliation is successful it does not, of course, demonstrate completeness of data – merely that some losses are separately identifiable in the general ledger.

The magnitude of this point should not be underestimated – it carries with it the potential to fatally undermine the workability of the AMA for firms.

The positive elements of CP10

As mentioned above, we find one phrase in paragraph 449 exceptionally helpful. This reads: "significant components of the operational risk measurement system are still evolving in the industry". This is absolutely crucial for any understanding of how to operate a set of rules for firms' management of operational risk.

Paragraph 455 – It is notably helpful that this paragraph spells out (in its final sentence) a fact which has been very clear in the minds of many firms' operational risk specialists since before the conclusion of the consultative phase of updating the capital rules; namely, that "exactly how the four elements are combined (ie, the weighting of the four elements) is up to the institution". This is a clear and functionally vital corollary of the points we make about the firm-specific and evolutionary nature of operational risk management.

In the same vein, we also applaud paragraphs 444 (on data quality) and 482 (on the operational risk management function). Both of these paragraphs are good examples of principle-based guidance that assists interpretation of the capital rules without being overly prescriptive or reducing flexibility.

- We are not sure where this comes from, was this discussed at one of the meetings? (this repeats a "typo" we pick up at the end)Para 482: "Operational Risk Management Function (ORMF) designs, develops implements, executes, and maintains <...> measurement methodology". It should be clarified that tasks can be delegated as is common practice. (We do not disagree with this, but do not recognise this comment?)

Internal Governance

Section 4.3.5 (paragraphs 469 to 476) on Internal Governance impose specific, prescriptive obligations on banks' supervisory bodies and senior management in relation to Operational Risk. For example, banks' supervisory bodies are made responsible, together with senior management, for the approval of:

- all material aspects of the risk management framework (e.g., all activities aimed at identifying, measuring, monitoring, controlling, and mitigating OR)
- specific levels of acceptable risk; pro-active risk management strategies and policies
- the whole project, goals, implementation structures, time to completion, costs and benefits
- overseeing Risk Control, OR and ORM on an ongoing basis

Banks' senior management are required, for instance, to:

- have "extensive" understanding of credit & operational risk policies and risks
- ensure that all components of the IRB system, including controls, are functioning as intended.
- define the content of IRB and OR reporting to the supervisory body / delegated bodies
- take responsibility for ensuring that before new products, activities, processes and systems are introduced, the OR is subject to adequate assessment
- monitor and manage all sources of potential conflicts of interest
- ensure all the staff are aware of the relevant policies and procedures; etc

These prescriptive requirements could mean that firms would have to substantially modify their board and management structures, and as stated above (in the section on credit risk) we do not believe that this was the intentions of the CRD text. We therefore recommend that CEBS drop the prescriptive OR requirements for banks' (institutions') corporate governance bodies and senior management. Instead we recommend that CEBS provide just high level guidance.

Overly detailed paragraphs

There are a number of points where we believe the CP to have carried the treatment of operational risk into territory that is too prescriptive. Perhaps the most significant of these concerns the **Use Test**.

We are broadly comfortable with the higher level principles (1 through 4) laid out after paragraph **437** (though see the other issues section of our response, below); but we do not believe it necessary or wise to include the examples. Among these, we would direct the most questions at the second ‘example’ under principle 2 (on the responsiveness of the risk measurement system) and the first under principle 4 (on senior management action). Both these implicitly carry the dialogue between supervisor and supervised into a level of granularity that would cause considerable work but, arguably, without ever being able to meaningfully satisfy the requirement.[2] Overall, however, we stress our view that all of the

[2] The Use Test has been the subject of considerable discussion in national implementation debates between industry and regulators. This has included discussions in the UK, where industry believes that the final form of the Use Test document published on the FSA web-site is instructive in terms of the level at which the guidance is set. The link to the paper is: http://www.fsa.gov.uk/pubs/international/orsg_use_test.pdf

text after para 437 should be restricted to the principles that appear in bold in the text of CP10 (subject to suggested amendments).

- Para 431: It is unclear to us why a further procedure needs to be created in relation to assessing an **AMA roll-out**, in the form of the three options set out. This overcomplicates what is already a complex process. The paragraph could achieve essentially the same effect by ending at the sentence that begins "To facilitate this process, institutions should…"; with that sentence amended to read "….should work with supervisors and review the roll-out periodically."

- Para 438: This paragraph seems acceptable, provided it is taken together with para 439, which makes clear that it is left to firms to determine the exact **structure of the IT** designed to deliver the results required under para 438.

- Para 440: As a general point we would prefer phrasing that simply required **adequate and appropriate IT** to support the management of operational risk. We particularly question the intent and functioning of the requirement (in the second bullet) to have capacity "at all times". This appears to us to be poorly conceived and potentially impossible to guarantee or police.

- Para 442/2nd bullet: *See comments on para 445 below, on reconciling to the general ledger.*

- Para 443: High-level standards on **data consistency** would be more in keeping with the AMA, where different models may make use of different forms of data in different ways. They would also be more consistent with the approach outlined in the US 'ANPR', thereby avoiding an un-level playing field at the global level.

- Para 445: While this constitutes another example of a paragraph where we view the detail as unnecessary and potentially damaging, we are especially concerned about the final bullet. This embodies (albeit without using these exact words) the notion of **reconciling to the general ledger**, which we view as an especially burdensome requirement. (We elaborate on the nature of this burden towards the end of our introductory remarks, above.) The same issue arises in relation to para 442, second bullet point. Please note that various forms of internal sign-off will already offer assurances as to coverage of risks, notably sign-off related to internal audit and to compliance with corporate governance codes (such as the Sarbanes-Oxley requirements).

- Para 448: As with the text relating to IT systems (para 440, discussed above), it is important that this be reconsidered. We have no doubt whatsoever that the paragraph would be immeasurably improved by condensing the requirements down into one, overarching requirement for appropriate **documentation of data standards** and systems.

- Para 452: Although the high level principles of the AIG paper on Validation are, when taken very generally, relevant to the AMA, the examples included in the AIG's document focus solely on IRB validation. If CEBS were to provide additional guidance in this area, consideration should be given as to whether the principles should be adapted for AMA purposes and how the accompanying examples could be modified to apply to AMA validation.

- Para 473: We advise removal of the last sentence. It is not clear to us why this particular activity (**new product review**) is highlighted, when no single activity should be.

- Para 474: It is inappropriate to set "tasks" for a **management body**, when its proper role is oversight. Moreover, in paragraph 482, the paper provides a perfectly good outline of the responsibilities of the operational risk management function.

- Para 481: Paragraph 481 should, in our view, stop at the end of the first sentence. It would simply read: "The design of the **reporting framework** is the responsibility of the institution."

<u>Other issues:</u>

Partial use tables (after Para **418**) – We believe that the rationale for the various permissions and restrictions should be clearly spelled out. Over and above that, we view it as inconsistent (and not directly justified by the Directive) that, while a group-BIA/subsidiary-AMA combination is deemed acceptable, an entity-BIA/business line-AMA combination is not. Many groups manage across borders by business line and may well wish to develop an AMA for larger entities that are predominantly engaged in one such line (for which, in addition, internal loss data may be more readily available), while running BIA for smaller entities for which the line is less significant. The prohibition appears to conflict with such practice, leading to a potential discrepancy between regulatory and economic capital assessments.

- Para 424: It may be helpful to clarify what the **consequence** would be of **ceasing to qualify for the ASA**. Ideally, this should allow a move to the approach that made most sense for the individual institution, but in any case some clarity and consistency on this point would not be amiss.

- Para 427: We question whether it is the **"method" of calculation** that would change, or the amount (of gross income) by reference to which the capital charge would be calculated. It seems to us that the term 'indicator' would be the more apt.

- Para 428a): We believe that, where a subsidiary is calculating a standalone AMA, the coverage of operational risks that this affords should count towards **coverage of the *group's* operational risks**, in satisfaction of the requirement in this sub-paragraph. This is a nuance of interpretation, but potentially an important one.

- Para 429: The wording relating to the **materiality assessment** strongly suggests a detailed, in-depth process, whereas it would be more appropriate to adopt an approach of self-certification.

- Para 437: All four **use-test** principles should follow the line of the third, and refer to the operational risk 'management framework', rather than the 'measurement system'. In addition, the word "continually" should be removed from the second principle, as this implies that change should be made for change's sake, rather than as truly needed.

- Para 443: The requirement should focus not on the **movement of data** but its quality.

- Para 450/1st bullet: we believe that this text requires the words "if any" or "if relevant" after the word **"methodologies" (for scaling)**.

- Para 451: This is a list (on **issues related to quantification**) that we applaud. In fact, we would add to this list, noting the importance of the issue of allocating capital to subsidiaries, taking into account the diversification effect that these bring. In this context, we note the practical importance to risk assessment of proxy data, possibly from other parts of the same group, where internal data is not plentiful in relation to an individual subsidiary.

- Para 452: The reference to **(IRB-related) validation standards** in section 3.5.1 of the same paper seem to us misplaced. It is difficult to translate standards relating to internal ratings into the context of operational risk. At the very least, there should be a health warning about trying to attempt this, but the more logical solution would appear to be to abandon this attempt at parallelism.

- Para 456/2nd bullet: We believe that the second bullet point does not add anything material on the **use of the four elements**, especially in light of the last sentence of para 455, which we have already highlighted as welcome. In fact, the second bullet of para 456 constitutes a potential source of confusion. We recommend at least a radical revision to bring out the intended meaning, but preferably deletion.

- Para 464: It is problematic that, in relation to the question of allocating a portion of group-level AMA capital to subsidiaries (without conducting a standalone AMA calculation for that subsidiary), CEBS, albeit in line with Directive, does not appear to recognise the possibility of an entity having a **parent from outside the EU**. In our view, the word 'EU' should be deleted from both the phrases in which it appears in the first sentence. This would help to level the international playing field.

- Para 477: We advise removal of the last sentence, as such **reports** would appear to us to be available to supervisors in any case.

- Para 489: We suggest a reworking of the first sentence, which we believe would more fully bring out the meaning. (We view this meaning as linked to what is set out in the preceding paragraph, 488.) The following wording (with our emphasis added for clarity) would result: "**Internal Audit** should develop a programme for reviewing <u>whether</u> the operational risk framework covers all significant activities…."

<u>Typographical errors:</u>

- Para 409/1st sentence: 'Business Indicator Approach (BIA)' – should be 'Basic….'
- Para 431.3/1st sentence: words 'roll out' repeated.
- Para 462/2nd sentence: 'one year or less' should presumably read '… or more'.