Fédération Bancaire Européenne
European Banking Federation

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DRAFT RESPONSE: CEBS CP10

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

1. The European Banking Federation[1] (FBE) welcomes the opportunity to comment on CEBS' consultation paper on the procedures European supervisory authorities will be expected to use in processing, assessing and making decisions on the application of an institution to use an Advanced Measurement (AMA) or an Internal Ratings Based (IRB) approach for regulatory purposes.

2. CP10 sets out guidance based on supervisory authorities' common understanding on the meaning and the implementation of the minimum requirements for using these approaches, as set out in the Capital Requirements Directive (CRD). We welcome this objective. However, we believe that the proposed guidelines fall short of meeting the stated goal. We encourage CEBS to continue to work towards convergence in the implementation, validation and assessment of the IRB and AMA approaches.

3. Our comments firstly highlight where industry foresees practical difficulties with the application of the proposed guidance and secondly asks CEBS for clarification of its intentions or definitions.

I. GENERAL REMARKS

4. We welcome CEBS' "goal to reduce inconsistency in implementation and supervisory practices that are within the competence of the supervisory authorities". We also support CEBS' objective to "promulgate best practices in banking supervision and risk management". However, CP10 fails to use this "unprecedented opportunity to make progress" and to set up best practices which are will be applied consistently by all supervisors and which are in line with the reality of banking practice.

5. Furthermore, we believe that CEBS lost sight of the reality of the validation process for banking groups. Both application packs and 'business as usual' documents must be kept updated on an ongoing basis which will be extremely difficult to comply with (for example paragraph 67 requires the bank to provide information in all necessary languages including translating updates). This administrative burden will essentially create a disincentive for banks to apply for the advanced approaches.

[1] Set up in 1960, the European Banking Federation (FBE) is the voice of the European banking sector. It represents the interests of over 4,500 European banks, large and small, with total assets of more than €20,000 billion and over 2.3 million employees.

6. Overall, the guidelines proposed by CEBS contain a great deal of detail, which in some cases is not sufficiently clear. CEBS runs the risk that the proposed guidance could cloud the understanding of concepts already established by the Basel Committee, during the negotiations on the CRD and in expert groups on national implementation. Indeed some of the provisions set-out in CP10, and in particular in relation to the use-test, could raise interpretative questions about the CRD provisions. We acknowledge that some of these interpretive problems arise because it is not always clear in the text where CEBS intends to provide examples and where CEBS is explicitly referring to the CRD provisions.

7. The industry is concerned by the **timing of the consultation** which may result in setting new standards, particularly as far as the application process is concerned, while many institutions are already in a pre-application phase and are striving to meet the requirements of their home supervisor. Where forms have already been issued by national supervisors, those should be the only form that banks currently applying should have to complete. There must under no circumstances be backtracking in the current process. While CEBS' proposals may be useful for harmonising future applications, they should not result in supervisors or banks having to duplicate work which is already well-advanced.

8. While it is true that there are differences between the application packs designed by different supervisors in the EU, this is not an urgent problem given that the application will only be made once, at the level of the group using the application form and the requirements of the consolidating supervisor. CP10 comes too late to address this issue and any attempt to do could result in more administrative burden than that arising from inconsistencies.

9. The FBE strongly advocates that the proposed guidance should be **'top down' and principles based**. It should deal with only the most important issues and at all times respecting the level playing field. We recognise that it is difficult to achieve convergence of practices without a certain level of detail. However, CEBS should endeavour to identify areas where granular harmonisation is necessary. In other areas, such as internal governance, a principles-based approach is more appropriate. Detail across the board, as is included in CP10, results in an addition of national practices rather than truly delivering European standards suitable for cross-border European banks.

10. Furthermore, CP10 is not consistent with other CEBS guidance. In particular the internal governance guidelines are in contradiction to CP03 which takes a principles based approach to governance issues. It is not clear why CEBS has chosen to go beyond CP03 in this respect. Contradictions with CP09 are also evident particularly in relation to the determination of significance.

11. The proposals CEBS put forward on occasions tend towards **excessive conservatism** and often include requirements that go **beyond the scope of the CRD**. We believe that the contents of CEBS' guidance should not go beyond the parameters established by the CRD and that a better balance must be found within the Committee between the more 'light touch' and the more conservative regulatory cultures within its membership.

12. In the spirit of these remarks the FBE also regrets CEBS' intention to release guidance on Stress LGDs in CP10 Phase 2. Downturn LGDs should not be included in the Pillar 1 framework: downturn periods are adequately treated through stress-testing under Pillar 2. Furthermore, the calculation of downturn LGDs is an evolving process which cannot advance until there is concrete data from real-life

experience. Supervisors should not under any circumstances endeavour to drill down into this subject now. It is inevitable that the result would be prescriptive guidance which would not be based on the necessary data.

13. Industry believes that the guidance is overly burdensome as regards how a bank must structure its **internal governance**. If CEBS' guidance were to be implemented strictly, the shape of banks' businesses would in effect be dictated by legislation and guidance which could reduce an institution's ability to organise itself to carry out its day-to-day business and best serve its customers. We believe that the standards set in the paper are excessively intrusive and interfere too much with the responsibilities of both the supervisory and management functions. Again it is unclear to us why CEBS has chosen to go beyond the appropriately principles-based approach set out in CP03. We would urge CEBS to cross-reference the two papers and to ensure consistency between them.

14. The FBE does not believe that the application pack as set out in CP10 will be an efficient vehicle for information transfer between supervisors. The level of documentation required would be excessive in the extreme and would not contribute to enhancing the home/host framework. The documentation involved in describing the internal practices of the group and all of its entities (procedures, processes, policies, rationale behind every step, etc.) will result in piles of paper which do not always add value and which, in fact, supervisors cannot handle. CEBS should distinguish between the "need to have" and the "nice to have" documentation.

15. In this context we would encourage CEBS to examine the possibility of developing a "qualification certificate" produced by the home supervisor which would provide a summary of its assessment of the group to the host supervisors. Host supervisors could use the qualification certificate to identify information needs concerning their local circumstances. The resulting information requests could then be routed through the home supervisor to the group.

16. Finally, the FBE believes it is important for CEBS to make reference to the global perspective in the paper. Our detailed comments notwithstanding, CEBS has done valuable work on home/host issues and we fully support the role that this work is playing in shaping the thinking of supervisors in the Accord Implementation Group. We believe that CEBS should mention its global outlook in its CPs.

17. Some general remarks are that the paper focuses too much on the back office with no explicit mention of front office. There should be a more balanced approach. It is also not entirely clear to us whether the paper was written on the basis of the Commission's original proposal or the text of the CRD as amended by the European Parliament. We have particular concerns in respect to conversion factors and the amendments to Article 84(4) and Annex VII, part 4.

II. GENERAL QUESTIONS

18. The following section sets out the FBE's response to the five broad policy questions at the beginning of the Consultation Paper.

Regulatory level playing field

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

19. Assuming that European supervisors take account of CEBS guidance in the spirit that it was intended, that is in order to facilitate regulatory convergence, then the proposed guidelines would enhance a regulatory level playing field for EU institutions using an AMA or IRB approach. However, industry is greatly concerned that supervisors may exercise their right to impose stronger or more detailed requirements than those set out in the guidance.

20. The approach CEBS follows of detailed and prescriptive core guidance plus supervisory discretion to add national requirements has the potential to seriously jeopardise any notion of establishing a level playing field for banks. The FBE believes that, as stated in paragraph 9 above, the guidance on validation needs to be principles based and supervisors must adhere to those principles in a consistent and uniform manner.

21. The economic and competitive detriment to the Europe's banking industry from working with an unlevel regulatory playing field in the Single Market is well known. Therefore, we strongly urge CEBS to seek to persuade its member supervisors and to reassure the industry, that any divergence from European standards will be limited. Where deviation from the European norm is unavoidable, we request that it be disclosed and made public so that the industry can make informed choices about competing national supervisory regimes.

22. Furthermore given the proposed level of granularity and prescription in the CEBS papers, CEBS should be concerned about the resource burden that they are imposing upon regulators at a time when some regulators are still working on their CRD principles and frameworks. Insufficient regulatory resources, nationally or EU wide, will increase the likelihood of an unlevel playing field. It is right that CEBS intends that the proposed guidelines will apply to all sizes of bank, large and small, irrespective of their activity. We also acknowledge that national supervisory authorities will aim to be proportionate in their decisions regarding implementation, validation and assessment of the AMA and IRB approach.

23. This principle should explicitly recognise that proportionality is equally important for larger financial institutions as it is for smaller ones. It is important not only to take account of the risk to a supervisor's objectives that may be posed by the size of a bank but also the levels and complexity of managerial structures involved. Hence for larger institutions it should be recognised that senior management and the Board of Directors may distribute the responsibility for approving relevant risk policies, in particular the policies that have a high technical content, amongst the appropriate senior management levels within the bank

24. We stress that is of the utmost importance that supervisors arrive at their conclusions in dialogue with one another as well as with the firm in question. This way a firm in one Member State will be treated in broadly the same way as a firm of a similar size and profile in another Member State and a level playing field for decisions will be established. Therefore, we strongly support the guidance set out in, in particular, paragraph 35 of the consultation paper regarding how supervisors will be advised to communicate with their fellow supervisors and the banking group.

25. However, in general we feel that there is a lack of emphasis on dialogue with the institution in the paper. For example, in paragraph 82 it says that a joint decision could be the dismissal of the application. While this is indeed true, it should be clear that the rejection of an application at the decision stage should only happen in exceptional circumstances. If there has been sufficient dialogue with the institution in both the pre-application and application phases, it seems strange that an

application would be rejected at the end of the application process without the institution having made the adjustments necessary to avoid this situation.

26. We highlight the importance industry places on the ability of an institution to move between supervisory approaches, from the Standardised Approach (SA) to IRB to AMA. The incentives to move from one approach to the next must be evident in the guidance CEBS sets out in relation to implementation, assessment and validation. There must also be a consistent approach from European supervisors to the conditions under which an institution can move between approaches. Failure to address this issue sufficiently clearly in the guidance could seriously undermine the level playing field in Europe.

Supervisory co-operation

Do you support the proposed procedures for co-operation 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?

27. In line with our response to CEBS CP9 on supervisory co-operation, the FBE believes that the theoretical framework proposed by CEBS for cooperation between home and host supervisors is welcome and well-reasoned. It will of course be necessary to see the network mechanisms working in practice before either CEBS or industry can judge their efficacy. However, early reaction from the banks to the growing level of cooperation between their supervisors within the colleges is positive.

28. The FBE welcomes the reference to the practical role the consolidated supervisor would fulfil as the coordinator and the central point of contact for the group throughout the process of applying and moving onto the advanced approaches. We also welcome CP10 as the first development of the consolidated supervisor's role under Article 129. It is extremely important that there is a common understanding amongst the supervisors on how Article 129 will work in practice and on how the final decision will be reached if there is no agreement within the 6 month period.

29. We feel that there is a lack of clarity around the division of duties expected of the home and host supervisors and the clearly defined areas where supervisors are expected to co-operate and agree. In particular, there is more clarity needed in the different divisions. Such practical guidance is not only useful for the supervisors themselves; it also allows industry to prepare whilst managing its expectations about what can be achieved and within what time frame.

30. However, we note that the paper is silent on the arrangements that could be expected between EU and non-EU supervisors during the implementation phase. We therefore call on CEBS to provide clarity on how it envisages such a process will work focussing on how far there would be a commonality of approaches amongst supervisors from within and outside of Europe especially in light of the recent announcement of a delay in implementation by the US regulators.

31. The FBE makes a number of more detailed remarks below on the co-operation arrangements which, if addressed would enhance the efficiency and consistency of the process and subsequently lead to a reduction of the administrative burden on the industry and its supervisors alike.

Supervisory convergence

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?

32. Promoting a common understanding among European supervisory authorities in order to bring about some degree of harmonisation of supervisory practices is the right objective in our opinion.[2] This objective must be pursued with vigour and intent if implementation of the CRD in Europe is going to be efficient and proportionate and on time. However, convergence of standards is more urgent in some areas than in others. In our view, CP10 comes too late in the process to deliver useful convergence. As banks will only make a single application to their consolidating supervisor, the need for harmonisation now in this area which could result in an added regulatory burden, is not evident. We feel that the objectives of CP10, though not the substance or the level of detail as it currently stands, could usefully used for harmonisation of the validation process for future applications but not the first phase.

33. We also understand that the proposed guidance represents convergence around a fairly onerous implementation regime and is actually more burdensome than that will be required in a number of important EU jurisdictions. CEBS must therefore assess how it can reconcile the needs of supervisors who typically demand a greater degree of information with those that impose less burdensome requirements on the industry. This is also in line with our comments on CP05 on CoRep. There is a need for CEBS to produce real European standards and not to collate the practices of all European supervisors. Industry repeats its call for harmonised principles-based guidance around the minimal requirements. This in our view would represent convergence around the best practice or the most efficient approach, in Europe.

34. Whilst we acknowledge that it would not always be easy to achieve consensus around the least burdensome approach to implementation within CEBS membership, this must be the long term goal for the Committee. An overly burdensome approach to implementation, with the possibility of national supervisors then adding further requirements at their discretion undermines the good intentions of CEBS in respect of convergence. For CRD implementation issues, CEBS should instead set 'parameters of acceptable divergence' between European supervisors, which we would expect to see narrow over time, to truly bring out the convergence of standards and regulatory culture in Europe.

Areas of greatest relevance

Has CEBS focussed on the areas of greatest relevance to the industry?

35. We agree that banks' management must assume responsibility for the risks banks run in the course of their day to day basis. However, we believe that the internal governance guidance offered by CEBS implies and management and an organisational process which may not be appropriate and may ultimately impinge upon the fundamental responsibilities of the supervisory and Executive management bodies. We do not, therefore, believe the Internal Governance

[2] The issue of whether or not the proposed guidelines truly facilitate supervisory convergence is closely linked the points related to establishing a regulatory level playing filed which is covered earlier in this response. Therefore, some of the comments in this section may be relevant for those in the previous section on level playing field and vice versa.

guidance as set out in CP10 to be relevant for the industry. CP03 relies on high-level principles in Internal Governance. It is neither clear why CEBS has written new guidance nor why that guidance is inconsistent with CP03.

36. The guidance on credit risk and operational risk are both relevant and important for industry. However, we regret that the level of detail that CEBS has included represents a sum of different supervisory practices. Within the FBE we have found that while certain areas of the guidance is relevant to some Member States, other areas are relevant to different Member States. Rather than CEBS reaching European standards, it is possible to identify which national supervisors have drafted which parts of CP10. In our view this is regrettable and will lead to a lack of clarity for banks who are already coping with different supervisory cultures. It demonstrates that CP10 does not reach its target and should therefore undergo serious revision.

37. Regarding the level of detail, it is also unclear to us why, for example, CEBS sees the need to set out basic lending practices as in part 3.6.4. Throughout the paper there is a tendency to go into great detail on procedures which should be familiar to both supervisors and practitioners. This adds unnecessary complexity and length to the paper.

Other areas of importance

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

38. The FBE does not believe that there are any further areas of work which should be covered. In fact we think that it is absolutely necessary to scale-down CP10.

III. SPECIFIC REMARKS

Chapter 2: Cooperation procedures, approval and post approval process

39. We generally support the views set out in this chapter and particularly welcome the strong position of the consolidating supervisor. We would, however, reiterate our call on CEBS to develop a "qualification certificate" for ease of communication between the various supervisors. The qualification certificate should be produced by the home supervisor in dialogue with the group and should include the main qualification points and the compliance assessment by the home supervisor. The host supervisor could then use the certificate as a basis for information requests to the home. This does not preclude the possibility of the host supervisor approaching the home supervisor on local issues. However, we firmly believe that the home supervisor is best placed to understand issues relating to the group as a whole. CEBS should also introduce this idea to the AIG to facilitate the work of the global colleges of supervisors.

40. The FBE highlights the following specific points:

    Paragraph 38: The interaction between the pre-application phase and the application process is unclear. Banks do not want to go through multiple qualification processes. The formal application stage should only be the conclusion of the pre-validation work and must not involve duplication of duties.

- Paragraph 40: Although we do not disagree with this notion, it should be clear that this does not imply host supervisors to interfere heavily in the process. We hope that this will not be the case in practice as it is certainly not intended under the home/host framework as developed in CP09.

- Paragraph 43: We place the utmost importance on Supervisors having an ongoing dialogue with the banking group. Therefore, in the event that supervisors can't agree, albeit an exceptional circumstance, we feel that banks should be kept abreast of the situation.

- Paragraph 47: If the application pack is to be legally binding, supervisors must accept a strong disclaimer for the fact that changes in banks' portfolios, activities and organisational structure occur daily. Only material changes during the six month application period should lead to an obligation on the side of banks to update the application package.

- Paragraph 48: The official application form should be built on the outcome of the pre-validation phase and must not imply replicating what has already been done.

  Likewise, we believe that Supervisors would get a more representative impression of a bank's application if there were to be more emphasis on dialogue rather than the compliance with a prescribed document request.

- Paragraph 54: ' differences between the calculation of risk weights for regulatory and internal purposes': this should be rephrased as economic capital does not work on the basis of risk weights. More appropriate would be to request 'differences between the calculation of used parameters for regulatory and internal purposes'.

- Paragraph 57: We are of the opinion that the general information required on an institution's IT infrastructure is not relevant for the approval and post-approval process. In fact, we feel that the requirements only serve to increase the burden on institutions.

- Paragraphs 62-64: On the issue of self-assessment, guidelines are given on who should be responsible for implementation. We do not see the need for any guidelines on this issue. Since these are internal assessments by the banks themselves, it should also be possible to decide internally who should conduct the assessing. We therefore suggest deleting these proposals and replacing them with broader themes as opposed to a detailed process.

- Paragraph 67: The costs of translation would imply a high level of burden for banks. Any translation should be at the discretion of the bank. If the concept of a qualification certificate is introduced, it would be appropriate for it to be prepared in English.

- Paragraph 74: Employing external staff in the validation process by supervisors could lead to potential conflicts of interest, in particular if the external staff is sourced from consultancy firms.

- Paragraph 75: " meet all other minimum regulatory requirements' : please add; 'insofar as applicable' (not all requirements apply under all approaches or to all banks)

Chapter 3: Supervisor's assessment of the application concerning the minimum requirements of the CRD-Credit Risk

41. The FBE highlights the following specific points:

- Paragraphs 108-109: Strategic decisions that may require an alteration of the roll-out plan should not be limited to the reasons mentioned in paragraphs 108 and 109. Institutions must be able to decide how to allocate their resources. As long as thresholds are met and the supervisor is informed, deviations should be acceptable.

- Paragraph 110: CEBS should explicitly mention that for newly acquired subsidiaries some leniency is provided in terms of time lines and use test.

- Paragraphs 113-114: As exemptions are already subject to supervisory assessment, the bureaucratic burden of the required justification should be reduced. Cherry picking is already prevented by setting (low) thresholds and by the required supervisory approval.

- Paragraph 119: On permanent partial use CEBS states that an additional measurement of materiality is appropriate at a national level. This essentially introduces a new national discretion into the framework which would allow national supervisors to set thresholds limiting the use of the standardised approach for immaterial portfolios.

- Paragraph 120: We would prefer to have a more convergent approach whereby allowed immateriality percentages are aligned.

- Paragraph 129 and 133: It is unclear what assessment of differences means. In our views differences only need to be identified and explained.

- Paragraph 132: We hope the wording used does not mean restricting the way banks intent to manage their risk and more generally their business. For example, allocation of internal capital should neither be an obligation nor necessarily be based on regulatory capital. This comment is also worth for pricing.

- Paragraph 133: It should be clarified that the assessment of differences between internal and supervisory purposes is not an ongoing procedure, but only part of the approval process. The FBE also finds it unnecessary for high-level guidance to use technical language such as linear or homothetic.

- Paragraph 140: There is a lack of clarity in this paragraph and possible inconsistencies with other areas of the text. In earlier paragraphs (129 &139) there are references to possible “differences” in ratings and estimates used for internal purposes. However, paragraph 140 then refers to the final parameters being “strictly in line.” We would like to see a clear acknowledgement from CEBS that in some circumstances internal estimates are likely to differ from those used for external purposes.

- Paragraph 141: The requirement for mandatory use in the corporate exposure class of risk factors which can be derived from the financial statements should be dropped. It is true that Annex 7, Section 4, Paragraph 19 requires all relevant and material information to be used when assigning ratings. Nevertheless, this requirement can only refer to information which is available to the bank. If the bank has no information available from financial statements and is not legally required to obtain it as is the case in at least one Member State, it must be possible to assign a rating without using this risk data. In this area we would especially favour a principles based approach.

- Paragraph 148: The reference to risk measurement and management is unspecific. Any topic might be covered by that (see also Article 84(2b)). The requirements are subsequently repeated e.g. in the sections on data and internal governance. There is no consistency between requirements.

- Paragraph 156: We welcome the introduction of minimum thresholds on individual exposures and note that CEBS has based this guidance directly on consultation with industry. This is a welcome step. However, we highlight the potential for practical problems arsing with the guidance set out in the second bullet as regards how clients could accurately measure their exposures.

- Paragraphs 159 and 161: As regards the treatment of retail exposures we note hat CEBS offers a good deal of flexibility in paragraph 159 but effectively retracts this in Paragraph 161. We would be grateful for clarity on CEBS' intentions in this area.

- Paragraph 162: It is not true that "a significant number of exposures" implies that the number is large enough to generate reliable estimates of parameters; see, for example, "low default portfolios". This requirement should be dropped.

- Paragraph 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 provide data which is beyond the provision made within the CRD. We believe 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, flexibility is needed to make a determination of the volatility through other approaches, to the satisfaction of the supervisor.

- Paragraph 171: "So far no industry has been identified where this applies". However, countries have been identified for which banks would like to apply total assets rather than sales. In certain Asian countries P&L statements are unreliable whereas balance sheets can be relied upon to reflect a company's reality. In such cases, banks will indeed request their supervisors to apply the total assets indicator.

- Paragraphs 195 and 196: Analysing the ' cure rate' seems overly burdensome, and we would be in favour of setting thresholds by the supervisor.

- Paragraph 198-199: The definitions of realised loss and loss in LGD are unclear and potentially ambiguous. Moreover, we consider that requirements are too granular, especially as regards the data required to calculate economic loss. In this area we see that there is a reflection of indirect costs in industry practice and that the high level of granularity adds little value. Furthermore it would be essentially impossible from a technical viewpoint to capture all recovery costs at an entity level. The granularity could in fact lead to an arbitrary inaccurate measurement. The requirements also do not reflect the development of PDs in relation to LGDs and could act as an obstacle to evolution towards best practices in this fast developing area. This is a typical example of where the CP10 guidance could result in supervisory practice driving banking practice.

- Paragraph 203: The language in this paragraph is confusing. No clear distinction is made between "realised LGDs" and "estimated LGDs". Clarity is essential given concerns about data capture and the level of granularity between what is known and what can be inferred. WE urge CEBS to be as flexible as possible in this area to allow firms to develop suitable methodologies around the data available.

- Paragraph 205: The industry does not agree on this detailed definition of work out and collection cost. The concept of indirect cost is highly debatable and inclusion of corporate overhead is very arguable and is not a standard practice.

- Paragraph 206: There is some concern amongst the FBE's membership around the inclusion of indirect costs in the estimation of LGDs. The requirement to allocate corporate overheads with a high level of granularity is not in line with operating models where costs are held centrally. The prudential benefit from such a high level of capture would be disproportionately low to the costs of putting in place the necessary systems on a group-wide basis. CEBS must consider its guidance in the context of cost to the industry where the added-value is low.

- Paragraph 209: There should be more emphasis on expert judgement systems which use judgement to arrive at credit assessment using both qualitative and quantitative data.

- Paragraph 217: The requirement to record realised LGDs at as granular a level as possible is onerous and does not reflect requirements in some jurisdictions where it is generally more appropriate to record loss at the level of the operation.

- Paragraph 218: The requirement does not match with the important questions of calibration and validation of LGD parameters. A statistical estimator cannot fit with the requirement to estimate downturn LGD if there is not a permanent economic downturn period.

- Paragraph 219: We would request CEBS to add "…where necessary" after "…adjusting them to reflect their own positions".

- Paragraph 225: This is not part of the CRD framework and should be dropped. A Reference Data Set should not itself be adjusted, but the model into which it feeds.

- Paragraphs 231-233: There should be no prescription on how, or whether, firms should incorporate incomplete workout cases into LGD estimates, as long as they can justify their approach. This flexibility is needed as any requirement for inclusion would make no sense for workouts with binary payments, e.g. the liquidation of mortgage loans.

- Paragraph 237: "Use of market prices for defaulted exposures for LGD estimation in case of scarce internal loss data" enforces the use of probably unrelated information. This is unacceptable. The use of market data may be useful in some cases and inappropriate in other cases.

- Paragraph 245 ff.: The guidelines should be adapted to the wording of the CRD for CCF. EAD modelling is very restrictive by using CF on the undrawn amount – a common but very questionable modelling approach which is not suitable for aval lines, for example.

- Paragraph 247: The "momentum approach" (to calibrating CF) is mentioned here but only defined later in Paragraph 253. The two paragraphs should at the very least be cross-referenced.

- Paragraph 271: It would 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.

- Paragraph 277: The text appears to refer only to PD-ratings and is not appropriate as a requirement for LGD/CF calibrations/modelling. In No. 276 is stated, that section 3.3.4 applies to all kinds of model development and validation, including PD, LGD, and CF estimation.

- Paragraph 306: The mention of an independent party supposed to review the data quality is unclear. There should only be a reference to the internal controls of the institution.

- Paragraphs 308-309: These guidelines are too prescriptive to be practical. The particular approach (and minimum requirements for documentation) to verifying systems compliance should be left to the discretion of individual regulator in the context of existing national guidelines.

- Paragraph 311: The multiple references to conservatism are unhelpful. The approach should be based on maximising the data available given the level of conservatism already built into the CRD.

- Paragraph 312: Representativeness and/or comparability analyses require all key characteristics to be similar. Suggested criteria comprise distribution of the population according to the key characteristics and the level and range of these key characteristics. This is impractical as not every single driver can be representative in a development or test sample.

- Paragraph 323: The credit risk parameters mentioned in the guidelines are "PD, LGD and CF". This is ambiguous since a CF could mean either an estimate of a future Exposure at Default or the empirical parameter expressing historical drivers of EAD. In the case, the latter is meant it must be pointed that out that one parameter is insufficient for observing the drivers of EAD. In reality, two drivers (two primary credit risk parameters) exist: Empirical EAD's are determined by a) the propensity of obligors to use open credit lines prior to default (so-called "K-Factor") and b) the empirical behaviour of conversions from Non-Cash EADs into Cash-Equivalent EADs in case of non-cash products (so-called "CEEFW). Since these drivers do not behave in parallel, they should be incorporated into the EAD-methodology separately.

- Paragraphs 326 and 327: These paragraphs go into too much detail. A firm's analysis is likely to use both point-in-time and through-the-cycle models and expectations for the future which are neither point-in-time nor through-the-cycle. Notwithstanding what types of models are used, banks will endeavour to employ the most reliable data possible and to oversee that this is the case. CEBS should avoid putting in place requirements which would prevent innovation and evolution of these systems. Flexibility is, therefore, essential.

- Paragraph 337: Again CEBS refers to a higher margin of conservatism. Supervisors should not repeatedly call on banks to use arbitrary measurements when there is no evidence to suggest a problem with the existing data. In the FBE's view all of the requirements to apply a high margin of conservatism amount to capital add-ons by the back door.

- Paragraph 334: The document assigns an unrealistic role to Internal Audit which would essentially equate to super-validation. No bank, even the most complex, has access to sufficient experts with equivalent skill sets to replicate the modelling capabilities in the Internal Audit function. This unrealistic approach to Internal Audit is apparent throughout the paper (e.g. paragraphs 389, 392, 363 etc.).

- Paragraph 325: The guidelines require the verification of rating systems to be characterised by an appropriate level of objectivity, accuracy, stability and conservatism. This requirement of objectivity/accuracy, however, cannot be met with a conservative estimate.

- Paragraph 333: A validation concept that includes the assessment of qualitative factors is excessive, as this is part of the use-test and self-assessment. The rating system is again focused very much on the rating tool itself, but not the extensive interpretation of all IT systems and processes that are used (leading to a probable too extensive interpretation).The requirement to use the rating system as a core element in the risk management system already requires ("common sense") an institution to assess qualitative factors. How this issue is addressed does not need to be specified (except the guiding principle to validate the system).

- Paragraphs 360-364: This is an unnecessary discussion with regard to CRD Annex VII, Part 4, Paragraph 127. The detailed organisational set-up should be up to the institutions. The statement in no. 364 that the "coexistence of both functions (model development and model review) in the same unit should not be seen as an obstacle" is sufficient. This requirement for independence is not found in the CRD.

- Paragraph 365: The management body in larger complex institutions will delegate the modelling of the IRB and AMA systems to the appropriate senior management and committees. This should be noted in the guidance.

Chapter 4: Supervisor's assessment of the application concerning the minimum requirements of the CRD – Operational Risk

42. We expected the guidelines on the implementation, validation and assessment of the advanced measurement approach to offer further guidance based on the CRD. However, the document contains some very detailed requirements going beyond the requirements of the CRD. Even the relationship between the requirements in the CRD and those in the guidelines is not always clear.

43. Furthermore, international discussions have yielded certain insights into the challenges of operational risk management that have also been recognised by national regulators in talks concerning possible solutions. We believe that the guidelines sometimes fall short of this standard.

44. We would also appreciate clarification that the examples given are to be understood only as possible, not as exhaustive lists. Banks should have the option of using solutions over and above those mentioned.

45. The FBE highlights the following specific points:

- Paragraph 418: Table 2 indicates the partial use combinations in conjunction with a "solo capital requirement". In almost all cases the combinations are deemed unacceptable. During the discussions, however, it was indicated that a temporary partial would be possible as long as the bigger part of the legal entity was covered by AMA and the AMA roll-out plan indicated the completion of AMA implementation to a predefined degree within a certain time period. During the transition period, the AMA capital would be part of the bank's overall capital.

  We would therefore appreciate clarification of whether no. 418 refers to permanent partial use or temporary partial use pursuant to no. 428. We should like to stress

that Table 2's requirements represent an inappropriate restriction for the transition during the roll-out.

- Paragraph 429: *"Regardless of the methods used by competent authorities, all business lines and operations should be captured by one of the operational risk methodologies."* This does not adequately reflect the principle of materiality, in our view.

  Some non-material areas of the bank would be implicitly covered by the methodology applied to the group. The sentence suggests that, even for these areas, the operational risk methodology has to be explicitly applied. We would therefore suggest the alternative wording: *"…, all material business lines and operations should be captured …"*

  In addition, we would welcome clarification of whether prudentially prescribed business lines are meant here or whether a bank's own internal definition may be applied.

- Paragraph 430: The recommendation to start the roll-out plan with "the riskier of the remaining operations" should be dropped. The sequence of the roll-out plan is based on a number of criteria, not only on the level of risk of operations, but especially in dialogue with the consolidated supervisor.

- Paragraph 437: The use test is deemed an important element in the supervisory review and the model approval process. The principles, however, are described as non-exhaustive. In order to avoid expectation gaps, in-depth discussions between supervisors and industry should be launched. In consequence, we recommend amending the text as follows: "… *are neither meant to be exhaustive nor exclusive*". This would clarify that institutions can apply different approaches to meet the objectives of the use test.

- Furthermore the use-test requirements still leave a lot of room for supervisory discretion. It is, in our view, crucial that supervisors assess use test compliance in a consistent manner, and where non-compliance is penalised, this should be done in a consistent manner by EU supervisors.

  Our understanding of the term *operational risk measurement* as used here covers both input parameters as well as the result, that is to say the amount of the value-at-risk ratio, for example. We would appreciate clarification.

  Finally, concerning principle 4, the close relationship between the information resulting from the operational risk measurement system and management actions exists at lower organisational levels. Reports to the board, however, have more an informational character, since actions have been triggered already.

- Paragraph 438: We suggest deleting the list in no. 438. It confuses rather than clarifies and offers no real additional information.

- Paragraph 442: The reconciliation between operational risk loss data and accounting data is an issue which has been discussed in various settings. We do not believe that it is possible to reconcile operational risk losses to the general ledger.

  The following issues need to be considered:

- operational risk losses are not always booked individually (e.g. salaries will be integrally booked; overtime compensation due to operational risk will not be itemised);

- operational risk losses are not always adequately reflected in the general ledger (e.g. loss of assets which have depreciated);

- operational risk losses can be booked in a number of accounts: it will be difficult to filter all out;

- Operational risk losses sometimes need to be based on estimates: these estimates will not be booked.

- Therefore, we suggest rephrasing as follows*: a review for cross-checking* **material** *operational risk loss data with accounting data…*

- Paragraph 448: We believe it is superfluous to spell out specific requirements concerning the way data is stored and documented in operational risk management. Banks have general guidelines on recording and documenting data. These also apply to the area of operational risk management and should therefore be sufficient. This section should be focussed on the requirement to document data standards and systems.

- Paragraph 451: "*Minimum loss threshold <...> impact on the computation of expected and unexpected loss".* This is not a feasible assessment requirement. Impact studies on lowering the threshold are impossible due to the lack of data.

- Paragraph 452: The high level principles on validation for IRB are also valid for AMA according to no. 452. We take a critical view of transferring the application of principles in this way. On the one hand, CEBS refrains from providing more concrete guidance in view of the challenges of operational risk validation. On the other hand, reference is made to a set of general principles essentially developed with credit risk in mind. It would be helpful to see some examples for these high level principles like those shown for IRB in Section 3.5.1, since these examples cannot be easily projected to operational risk.

- Paragraph 455: A reference is made to scenario analysis providing "*information on extreme events"*. In the Basel International Convergence document and in discussions with national supervisors, however, the term "tail-events" was used. It was our common understanding that real extremes were not meant if applied to the capital requirements for operational risk.

- Paragraph 460: We highlight the well-known challenges associated with using qualitative data and the resulting limitations when it comes to measurement. With this in mind, we consider the proposed requirements unclear and unhelpful.

- Paragraph 463: The requirement "*automatic renewal option with terms and conditions similar to the current terms and conditions, and has a cancellation period on the part of the insurer of no less than one year*" cannot be adhered to under current market circumstances:

  - conditions cannot be given for a period over one year, this is explicitly true for the premium amount;

  - The usage of the term "cancellation period" is not clear. If the notice period is meant, the insurer is not able to grant a notice period of one year.

- The wording does not exactly reflect the CRD (*policies with a residual maturity of 90 days*) and, under a pessimistic view, most of the banks will not be able to use the risk mitigating effect in their risk capital calculations.

- Paragraph 464: We would like to stress that the requirements set out here go far beyond the wording of the CRD and that we are therefore highly critical of such a stringent stance. We would suggest rewording this paragraph completely. We would also point out that the diversification and correlation effects are deemed to be synonyms in the context on the section. After having calculated the risk capital on a group level, it is almost impossible to recognise the correlation effects in the allocation, since a retrograde approach is not possible. The final phrase should therefore be deleted.

  "Institutions are strongly encouraged to move towards allocation mechanisms that properly reflect the operational riskiness of the subsidiaries and their actual contribution to the consolidated capital charge." Some interpretations of this requirement imply that the capital allocated to a subsidiary should be determined by the delta between the total group and the group without the particular subsidiary in question. This raises concern over the unreasonable computational burden for firms using Loss Distribution Approach based calculations and may make some AMA group level calculations invalid, which is not in the spirit of the AMA.

- Paragraph 469: We would like to draw you attention to an incorrect reference. "*See paragraphs 347 to 349 for the definitions of these terms*" should be corrected to "… 357 to 359…"

- Paragraph 481: This paragraph should only read "The design of the reporting framework is the responsibility of the institution.

- Paragraph 482: The activities of "*Operational Risk Management Function"* include the *"design, develop, implement, execute, and maintain the measurement methodology*". It should be clarified that tasks can be delegated, as is common practice.

  Furthermore, *"back testing and benchmarking"* are listed as a task of the operational risk management function. While benchmarking is a useful validation technique in the context of operational risk management, traditional statistical back testing cannot be performed due to a lack of data. Therefore, we suggest removing the reference to back testing.

Sections 3.6 and 4.3.5 on Internal Governance

46. Sections 3.6 and 4.3.5 on internal governance impose specific, prescriptive obligations on banks' supervisory bodies and senior management in relation to credit and operational risk which go significantly beyond the text of the CRD, in our view. These prescriptive requirements could mean, for example, that institutions will need to substantially modify board level/senior management committee terms of reference and spend valuable board and senior management time on issues which could be successfully dealt with either by delegation or at a lower organisational level. We therefore recommend CEBS to drop the prescriptive requirements for banks' (institutions') corporate governance bodies and senior management. Instead, we suggest that CEBS provide high-level guidance as follows:

- CEBS requires institutions to assess matters which are relevant to their successfully governing and managing credit (and operational) risk and to assign responsibilities to their governing bodies and senior management.

- CEBS expects institutions to be able to explain and justify their approach to credit (and operational) risk governance and management when subject to external review.

47. The following issues need to be critically analysed:

- Paragraph 365: The first bullet point requires the approval also of the supervisory board for all material aspects of the overall Risk Control System. This should be reduced to an obligation for the board of managing directors to inform the supervisory board. Explicit approval should only be required from the managing board. The third bullet point requires all rating systems to be approved by the management body. The management body should be able to delegate responsibility and approval authority for technical details.

- Paragraph 366: See comment on no. 365, first bullet point.

- Paragraph 370: The envisaged allocation of functions to the supervisory function of the management body is not in line with national requirements and should be dropped (cf. also comments on previous paragraph).
- Paragraph 371: The requirements are not in line all national European laws. For example in Germany, national law already defines information responsibilities of the board of managing directors to the supervisory board. The primary recipient of internal reporting should be the board of managing directors. Information to the supervisory board (or its committees) should be based on those reports, but does not have to be identical or contain as much detail as required by this paragraph.

- Paragraph 377: The management body is already required to ensure the appropriateness of the control mechanism and measurement system on an ongoing basis (no. 369). This paragraph is inconsistent with that requirement in that the credit risk control unit is now called on to report in detail twice a year. Such detail could be assessed just as well by a senior committee. The reporting requirement should therefore be dropped.

- Paragraph 385: To fulfil these requirements it is necessary to subordinate the head of the control function to a person who has no responsibility for the activities that are being monitored and controlled. This technically implies that risk methodology and validation units may not be part of the risk management function, which is common practice in many institutions.

  Last bullet point: at least remuneration depending partly on the overall performance of an institution should be possible. The absolute character of this requirement should be avoided. Therefore, we see remuneration as an example.

- Paragraph 388: The decision on how to develop rating models and who should be involved should be up to each individual institution. This is an example of the inherent over-regulation of the guidelines, as the quality and application of rating methods within the credit process are already part of the directive and are even assessed by supervisors in the approval process.

- Paragraphs 389-392 (Internal Audit): The tasks of the internal audit defined in Nos. 389-392 go far beyond the requirements of Annex VII, Part 4, Paragraph 130.

These tasks require employees with strong mathematical expertise in the Internal Audit function. This is not necessary. It is our understanding that the internal audit function needs only a basic understanding of mathematical and statistical methodology. The sole task of the internal audit should be to examine the processes of model development and review, the processes of technical implementation of rating systems, the processes which should guarantee the quality of input data and the processes for inclusion of model output in the internal risk management systems.

- Paragraph 396: The definition of “rigorous controls” should be deleted as it is too extensive.