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The Committee of European Banking Supervisors
CP10rev@c-ebs.org

February 2006

Dear Sirs

CEBS SECOND ROUND OF CONSULTATION ON THE VALIDATION AND ASSESSMENT OF CREDIT AND OPERATIONAL RISK APPROACHES

The International Swaps and Derivatives Association (ISDA), the London Investment Banking Association (LIBA), the British Bankers' Association (BBA), and the European Securitisation Forum (ESF) welcome the opportunity to comment on the second round of consultation on the Validation and Assessment of Advanced Measurement (AMA) and Internal Ratings Based (IRB) Approaches ("CP10R") published towards the end of January 2006. Our combined membership represents a diverse group of internationally active financial institutions, operating across the broad spectrum of European and international capital markets.

We acknowledge CEBS' eagerness to finalise the guidelines, and welcome an early resolution to the outstanding issues from the first round of comments. However, we regret that the shortened comment period this time around prevents the joint industry group from providing the level of detail as contained in our previous response. While we acknowledge that CEBS is primarily seeking comment on the new sections of the paper, we have highlighted priority issues that we do not consider to have been fully addressed from the previous consultation. These, together with the key messages on the new material are outlined in the letter below. In Appendix 1 we focus on outstanding industry concerns from the first round of consultation and in Appendix 2, we attempt, in the short time available, to address detailed concerns and comments on the proposed new text.

The joint industry group recognise the effort CEBS has made in reviewing the range of industry comments submitted with a view to enhancing the paper, and we acknowledge those areas in CP10R where changes have been made in response to our previous comments. We

welcome many of the changes, and in particular recognition of the progress many of our members and their regulators have already made on their Basel II implementation work, and the informal application process. However, as we stated in our original comments, we strongly believe that the best way for CEBS to achieve its objectives and promote a level playing field in the validation and assessment of the IRB and AMA approaches at this stage is via a set of core principles for regulators to follow, rather than take the very prescriptive and detailed approach sustained and indeed enhanced in the revised paper. We do not believe this "mix of more detailed guidelines and high-level principles" (CEBS feedback statement) will be more effective in fulfilling CEBS' objectives. In fact we believe that providing this level of detail is likely to cause problems for some national supervisors in formulating their requirements within their own legislature, and could cause potential conflict or unnecessary duplications or complications with respect to local requirements already established (e.g. in Germany where the "Solvatibilitätsverordnung" (SolVv) provides the legal framework for the national implementation of Basel 2).

In particular, in the area of Operational Risk there is a strong feeling that this paper has disappointingly gone in the wrong direction in terms of level of detail (adding rather than streamlining). This has material consequences for implementation given the late timing of the proposed guidance. We are particularly surprised at this development because of what we consider to have been a clear, consistent and detailed message that came from industry in the public meeting on CP10 in London on 6th October. Yet the feedback statement associated with CP10R gives the impression that there was broad industry support for as much prescription as possible. Also this revised draft suggests that there have been calls for the same. We are not aware of any such calls, or of broad industry support. We therefore recommend that CEBS re-consider the level of detail contained within the paper as a matter of urgency and reframe the guidance to be more principles based in line with the basic premise for the CRD, which is a framework within which firms demonstrate compliance.

We also have concerns about the opportunities, given by the guidance, for national authorities to introduce super-equivalent requirements. It is our belief that CEBS should focus on generating a common understanding of the minimum requirement necessary to ensure proper implementation of the Capital Requirements Directive ("CRD") and therefore go no further than high level principles. This continues to be a significant issue for operational risk where detail designed to deliver consistent models is not necessarily desirable. The area of operational risk is one in which significant components of the risk measurement system are still evolving (and where the risk itself is evolving), and flexibility in regulatory guidelines is paramount to accommodate progress and not stifle developments in risk management. We think that regulatory focus should be on assessing the appropriateness of the particular model chosen for the firm and the risk that it is running. We think that CEBS should review the guidance with a view to allowing such flexibility. Such an approach would accord with the more principles based approach outlined above.

It is probably therefore no surprise to CEBS that on the matter of the very large amount of new text supplied, we view this inclusion as completely unjustified. The process by which this new material is being pushed into the public domain is not satisfactory, given the deliberate restraint shown with regard to AMAs in both the Basel Accord and Capital Requirements Directive. The new sections on Credit Risk (proposed guidance on securitisation, equity investments, purchased receivables and guidelines on downturn LGDs) do not provide further clarification, and while comprising only minor issues, are thus

superfluous. This large amount of new material is being introduced late in the day and is, in our view, at great risk of not undergoing sufficient review.

Furthermore, we believe the guidance CEBS produces in its Consultation Papers should be targeted at informing regulators, not firms, about the implementation of the CRD and thus be based on industry good practice and avoid introducing concepts, requirements or definitions that are new to industry practitioners. We would be particularly disturbed if the guidance introduced requirements that were super-equivalent to the CRD and have noted in our response below where we believe this to be the case. Such instances of super-equivalence should be removed, if they cannot be justified as a result of a cost-benefit analysis.

Additional Key Concerns

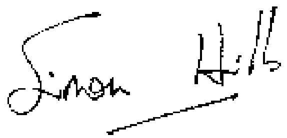
We are pleased to note that CEBS has recognised industry's progress in developing their systems on the basis of national guidance. However we have concerns regarding the way in which the 'good faith' clause, contained in paragraphs 8a and 14a, is framed. In particular, given the repetitions of the CRD provisions within the proposed guidance, we are concerned that the current draft suggests that the implementation of parts of the Directive itself may be delayed at a national level, which obviously can not have been the intention. In addition our members in some jurisdictions are concerned that the 'good faith' clause will cause a disparity of treatment across the EU. This is because the status of the CEBS guidance remains unclear, for some jurisdictions it appears that CEBS guidance in its entirety will be incorporated into national rules to be applied by firms, while in others a more selective, guidance based approach will be taken. We consider that as CP10R represents guidance to supervisors that the latter approach is more appropriate.

With respect to the section on securitisation, there is a serious concern that in addressing the national discretion for determining Significant Risk Transfer (SRT), CEBS introduces a number of issues, such as the references to accounting practice, that fail to provide the clarity and guidance that perhaps the supervisors' intended. CEBS' proposed guidelines in this regard (quantitative thresholds based on the percentage of losses retained by the originator as a first loss tranche) may not be consistent with a regulatory framework that applies capital floors to senior exposures and would likely result in many securitisation transactions not benefiting from regulatory capital relief. Furthermore, we note that contrary to prior industry comments CEBS has elected to provide further granularity and prescriptiveness through the inclusion of examples. While our preference is to avoid the use of examples, we would urge that any examples CEBS does use be factual and unambiguous e.g. they do not, in themselves, raise further issues open to industry debate. In view of the above comments, we believe that Section 3.3.1.3 should be re-written to better achieve clarity and consistency in interpretation with respect to Significant Risk Transfer, and we provide detailed comments as to how this can be achieved in the second appendix below.

The next section covers the important outstanding concerns from the first round of consultation, with an attempt to cover the additional new text proposed by CEBS in the following section. We would be happy to answer any questions you may have on our key remaining concerns 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), Simon Hills (simon.hills@bba.org.uk), and/or Carlos Echave (cechave@europeansecuritisation.com).

Yours faithfully,

Diane Hilleard Director LIBA	Edward Duncan Director ISDA



Simon Hills Director BBA	Carlos Echave Director ESF

Appendix 1 – Industry points raised CEBS ignored?

We continue to believe, as outlined in our earlier response (dated October 2005), that the proposals as drafted will not necessarily enhance the regulatory level playing field for our members. We believe that without clear objectives, with regulators at a national level allowed to impose additional stricter requirements and without further co-operation and co-ordination with supervisors outside the EU the guidelines could only achieve limited success. We would urge CEBS in circumstances where "no further convergence could be reached" (feedback statement) to refrain from attempting to provide detailed guidelines unlikely to achieve key objectives. In addition, although we supported the objective to "streamline the application and decision process", and approved of an agreed minimum set of documents to be included in the application process, we pointed out that explicitly allowing each authority the right to require additional application documents, immediately defeated this objective. CEBS could still go some way to achieving this objective by putting the onus on supervisors to justify why additional documentation can be requested from firms.

We also commented on the lack of any rank order or priorities in the original proposals (what are the key themes and objectives of the CEBS proposals?), and even though they covered some key areas of implementation on both AMA and IRB approaches, other significant topics had not been addressed. With the introduction of substantial new text CEBS has once again failed to provide clear objectives and rationale for the additional sections and in many cases repeated the requirements contained in the CRD. We originally suggested that given the level of detail in the Directive that additional guidance in certain areas, including in the area of securitisation, may not be necessary. It should therefore come as no surprise that this is a strong recurring theme in our more detailed comments on the new text in Appendix 2.

The more detailed comments below reflect specific areas CEBS failed to address in the first round of consultation that the industry believe would benefit from further review. In many instances should this CEBS' text become the minimum legal requirement in a member state, it could serve to hinder the bilateral discussions between the regulator and the firm, by causing confusion and possibly misinterpreting the intentions of the CRD.

Implementation plan:

- Para 58: Requirements regarding the implementation plan exceed requirements already laid out by some EU regulators. It should be clarified that no legal consequences are imposed on institutions whose AIRB applications have already been launched on the basis of national regulations (e.g. the SolvV in Germany, where Paragraph 63 deals with the IRB application).

The approval process:

- Para 74: This continues to allow for the validation process to "include off-site analysis or on-site missions, conducted by their own or external staff." This is bound to yield potential conflicts of interest, in particular if external staff (as confirmed by regulators) is sourced from consultancy firms.
- Para 80: The weakened version now only demands that "the competent authorities shall do everything within their power to reach a joint decision" on a bank's application. Thus the regulator's obligation to come to a conclusion after six months

is called into question – possibly implying that waiver application decision process can go on indefinitely.

EAD modelling:

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, we would expect CEBS to incorporate flexibility through the provision of high level guidance and not detailed rules. We also expect to place great reliance on CEBS' principle of proportionality (Para 21), and the understanding that work undertaken prior to the publication of CP10R will be respected by supervisors.

- Para 245: This paragraph by continuing to include a reference to undrawn amounts in the definition of CFs, effectively removes all potential for applying alternative EAD models. While the Directive is flexible on this issue, CEBS should not seek to continue to impose unintended additional restrictive requirements.
- Para 246: We welcome CEBS wording restricting requirements that Conversion Factors (CF) are estimated for "current commitments". We interpret this, and the second bullet of this paragraph, to infer that firms are not required to hold capital for creditor accounts. Until industry thinking has advanced, we strongly discourage CEBS from further prescription in this area.
- Para 251 – 253: We believe the requirement to adopt a 1 year period for the fixed horizon or cohort period when assessing CFs is super equivalent to CRD. This is compounded by the requirement that no other period may be used unless it can be shown to be more conservative than a 1 year period. It is also inconsistent with Para 143, requiring that "parameter estimates and modelling should be as accurate as possible" and with Para 242 which states the "CF, even more than PD and LGD, depends on how the relationship between institution and client evolves in adverse circumstances…" which implicitly recognises that in the assessment of CFs, banks should recognise the impact of their policy and processes around managing problem customers.
- Para 254: We do not believe that the momentum approach should only be viewed as a "transitory solution" and request recognition of proportionality, whereby for certain portfolios this may be considered a longer term solution.
- Para 261: The attempt here to accommodate a broader set of products (e.g. aval lines, as defined in our original response and for which the proposed CF approach is clearly unsuited) fails, as no clear statement is made on what "undrawn" means for guarantees.

Back testing:

- Paras 340 and 344: We believe the specific guidelines set out in Para 340 are inconsistent with the guidance in principle 5. Para 340 states that institutions should take action if internal validation thresholds (i.e. derived from confidence intervals) are exceeded; thus, Para 340 could be interpreted as "hard" thresholds for back testing. Principle 5 (Para 333) comprises both quantitative and qualitative elements for validation. This is stressed in the context of benchmarking and low default portfolios. Thus, "hard" thresholds for back testing or benchmarking results (as given here) contradict principle 5.

Implementation burden:

- Para 167: The unchanged text stating that "The benchmark level is to be the volatility of loss rates for the QRR portfolio relative to the volatility of loss rates for the other retail exposure subclasses" needs to be clarified, as some of our members understood this to be creating a circular reference difficult to put into practice.
- Para 168: The unaltered, connected requirement to measure loss volatility for all three retail classes poses an unacceptable burden and implies a high iterative workload.
- Para 352: "Limitations owing to the dataset should not exempt institutions to perform a quantitative validation in Low Default Portfolios" – this remains unchanged and represents a contradiction in terms as lack of data will not allow for useful quantitative validation. Instead we suggest CEBS include reference to supervisory expectations around the amount and relative importance of such quantitative validation techniques in low default portfolio scenarios, where more emphasis and weight is likely to be put on the more qualitative validation methods.

Unclear scope and definitions:

- Para 277: We still believe that this paragraph could easily be misinterpreted as the requirements do not differentiate between rating development and parameter calibrations (a supervisor could end up asking for the impossible, i.e. a "CF rating system" or "LGD model output" calibrated to default probabilities?)

Governance:

Despite some changes easing the demands for management body involvement in the governance of the IRB and AMA processes, some issues remain. For example:

- Para 364 and 370b: We are still concerned that the CEBS guidelines on the measure of independence go beyond the requirements intended in the CRD. The proposed guidelines still ask for a split between an institution's Credit Risk Control Unit and Credit Risk Control function. This is not backed by CRD. Even for large institutions, such independence cannot be achieved due to scarcity of skilled staff in general. Furthermore we would urge CEBS to remove the double reference to "audit" in the two paragraphs to refer instead to "another comparable independent unit".
- Para 385: Although the feedback statement claims to have amended the second bullet point to provide clarity, industry remain concerned that this could still be interpreted to mean that risk methodology and validation units may not be part of the same risk management function.

The Role of the management body and senior management:

Section 3.6.1 (and Section 4.3.5 covering Operational risk) continues to impose specific, prescriptive obligations on banks' supervisory bodies and senior management in relation to Credit (and Operational Risk). As we stated before, the requirements could mean that institutions will need to substantially modify board level / 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 this level of detail is consistent with the text in the CRD. We therefore strongly recommend CEBS to review this section and replace it with some high level guiding principles as suggested in our original response. Wording clearly stating that it is not expected that all senior management be expected individually to have a good understanding of "credit policies, underwriting standards, lending practices, and collection and recovery practices, and should understand how these factors affect the estimation of relevant risk parameters" would be very helpful. Without any limit of "materiality" or appropriateness, these guidelines could be very onerous.

Appendix 2 - The New Text

3.3.1.3. Securitisation exposure class

Our members welcome the opportunity to comment on the CEBS proposed guidelines on securitisation exposure class. Once again, we believe that the best way for CEBS to achieve objectives of consistent interpretation across all member states and prevent confusion around detailed provisions would be to provide succinct high level guidelines for core requirements. As such we believe that the guidance in the securitisation section of CP10R is too prescriptive. Industry considers that too detailed requirements are inappropriate as they will be unable to adapt innovative nature of the market and the diversity of structures available. This is particularly true of the sections dealing with significant risk transfer.

We also urge supervisors to adopt a risk-based approach to regulation rather than assuming an auditing type role (requiring a detailed consideration of each and every transaction at inception and on an ongoing basis) by the regulator, implied by the proposed guidelines. Supervisors should only want, or need, to look at those transactions where there might be some doubt as to the significance of the risk transfer. The proposed approach will also have implications for the supervisory authorities in terms of whether the necessary skilled resources are available to undertake such reviews. We believe that a risk-based approach, combined with normal supervisory discussions under the Pillar 2 provisions should provide supervisors with sufficient comfort to address their concerns.

We consider that it would be helpful to include guidance to the effect that where originators do not wish to obtain a regulatory benefit or where they do not meet the requirements for significant risk transfer, that they do not need to meet the other requirements regarding securitisation.

Finally, we suggest that it would be helpful to clarify that the provisions in the CRD relating to securitisation do not apply to securitisations of trading book exposures.

It is in this context that we provide below detailed comments relating to the individual paragraphs of this exposure class.

Definition of securitisation exposure class

- Para 187a: For the sake of completeness, and consistency with the CRD, we suggest that the final sentence of this paragraph should also make reference to the Internal Assessment Approach.
- Para 187c: We have interpreted sub-paragraph a) to mean that there are potentially more forms of first loss position than outlined in Annex VII, paragraphs 7 and 13. We welcome this clarification.
- Para 187c: To clarify the point made in brackets at the end of sub-paragraph c), we propose that the phrase below (in bold) be inserted so that it reads:
  "(I.e., senior and subordinated debt both default at the same time, and only the liquidation proceeds are distributed unevenly, while with securitisations, the default in respect of ***individual tranches*** *might occur at different points in time over the lifetime of the transaction.)"*

Indicators of 'significant risk transfer'

- Para 187e: For clarity we recommend that 'sponsor' is included within the first sentence of the paragraph. This is because sponsor is a separately defined term within the CRD and sponsors along with originators and third party investors may hold securitisation positions.
- Para 187g: We recommend that the text in parentheses is deleted. We do not consider the example cited helpful, since firms are not permitted to recognise future margin income under Article 57 in their capital resources. In which case, the existence of a spread account should have no bearing on the requirement for significant risk transfer.
- Para 187h – 187k: We propose CEBS delete the last two sentences of 187h, all of 187i and 187j, and the beginning of 187k up to '…accounting derecognition'. We do not consider that the addition of this guidance is helpful and we consider that the only guidance necessary is to state that accounting derecognition is neither a prerequisite for, nor evidence of, significant risk transfer. While we appreciate that CEBS' intention is to provide helpful guidance, our members have expressed concern over the references to accounting rules in the guidelines which is likely to result in risk measurement being inappropriately influenced by an accounting treatment that may not necessarily reflect the economic reality.

Quantitative evaluation remains necessary:

- Para 187l and 187m: As outlined above, we do not believe that the quantitative assessment in these paragraphs addresses the issue of transactions where no risk has been transferred from the originator, which we understand to be the purpose of the significant risk transfer requirement. Furthermore, we consider that the process envisaged with respect to the determination of significant risk transfer is not risk sensitive and would require a significant amount of regulatory resource. These proposals seem to require supervisors to assess the amount of risk transfer in each transaction at inception and on an ongoing basis. In addition, the assessment of whether the risk transferred is significant must be consistent with a regulatory framework that applies floor levels of capital to senior exposures. We do not consider that the guidance has captured this - for example, the designation of transfer of "tail end" or "catastrophic" risk (achieved by the sale of AAA rated tranches alone) as 'significant' should be incontrovertible.

ANNEX III

3 Tranched Cover:

We recommend that this paragraph is deleted, as we consider that the examples raise questions of practical implementation. In particular the last sentence does not provide any additional guidance merely highlighting a boundary issue. In regulatory terms a Credit Default Swap (CDS) will always be unfunded. If the CDS is collateralised then the collateral rules will also apply.

3.3.1.4. Equity exposure class

Nature of Equity exposures

We think further clarity could be provided to the definitions (e.g., classification of debt /equity swaps, measurement of “sufficiently diversified”).

Assignment of exposures to the equity exposures class

- Paras 187s-187x: We think the proposed guidelines should stick to the CRD definition of equity exposure as given by the CRD Article 86. Additional explicit criteria should not be introduced, but firms should be asked to introduce transparent and auditable internal processes and criteria for the classification of debt and equity products. This is important to retain flexibility regarding the treatment of products in accordance with market development. Products with debt- and equity-characteristics (e.g. Mezzanine) are an important and dynamic market segment. Therefore regulatory rules for the categorization of these products need to provide sufficient flexibility to keep up with the development of new products and structures in the market. Market judgement regarding these products takes several dimensions into account to determine the classification (see for example "Moody's Toolkit: A Framework for Assessing Hybrid Securities", Dec 1999, which analysis products along the dimensions "maturity", "loss absorption" and "No ongoing Payments" to place these on the "debt-equity continuum") and are not static. The proposed mostly one-dimensional provisions are not suitable for this purpose and might interfere with market developments (e.g. missing maturity - 187u (1)). Therefore, these criteria should not be introduced via CP10R. We believe this would be in line with the CRD, where no reference is made to the Basle II criteria although this would have been technically possible.

Deferral of settlement as a criterion for Equity exposure

- Para 187u (1): The fact that the issuer may defer indefinitely the settlement of the obligation should not automatically classify a product as equity. Classification should be based on a broader analysis of the instrument and not on single features. In this case, for example, step-up clauses can make repayment nearly certain, even if the issuer legally has the right to defer repayment. This is as well reflected in Moody's analysis, where perpetual preferred securities can be closer to credit than to debt depending on other features of the product. (see "Refinements to Moody's Tool Kit: Evolutionary, not Revolutionary!., Feb 2005, p.6)

Approaches for calculating risk-weighted exposure amounts for equity exposures:

- Paras188 and 188c: CEBS should not introduce additional criteria regarding the choice of approaches by the institution. ("approach should be chosen according to the general principle of adequacy and proportionality.", "choice made by the institution should reflect the size and complexity of exposures as well as the expertise available within the institution."). These criteria are not part of the Pillar I requirements in the CRD and could therefore narrow the leeway given by the CRD, especially with respect to the Simple Risk Weight Approach. These additional criteria should therefore not be introduced.

- Para 188c: The requirement to integrate the (regulatory) models into the risk management process is too prescriptive and unrealistic as banks will prefer and must be allowed to employ their own internal models to manage risks.

Active Management of private equity exposures in sufficiently diversified portfolios

- Para188d: CEBS should not refer to active portfolio-management as a criterion for sufficiently diversified portfolios. Sufficient diversification and active portfolio-management are different criteria. The CRD only refers to sufficient diversification and CP10R should not introduce a new, additional criterion.

3.3.1.5 Purchased Receivables

Firstly, it is pleasing to note that some clarity has been brought to the treatment of Purchased Receivables and in particular factoring/invoice discounting type transactions. In particular we support the clear and concise description of the relationships in this industry summed up in Paragraphs 188j-k. We believe the potential three treatments outlined in paragraph 188j provide flexibility which should accommodate the requirements of the invoice finance industry across Europe.

Industry welcomes inclusion of option one, which treats the seller as obligor, and which is in line with our successful discussions with EU regulators for recognition of this approach. Under this approach, in treating as an exposure on the seller, we assume that the "eligibility" of the receivables as collateral only applies in the Standardised and Foundation IRB approaches. It is our understanding that the concept of eligible financial collateral and eligible guarantors is applicable only under these approaches, it affecting the supervisory values of LGD and/or adjusting the effective value of exposures (the so-called E* measure). Own estimates of LGD under Advanced IRB are at the discretion of the financial institution, subject to supervisory approval, and are not subject to "eligibility" requirements.

Option two is essentially the original treatment proposed in the Basel documentation.

Option three allows for the invoice financier to develop Expected Loss via a pooled methodology in the absence of granular data on the obligor (debtors). Although theoretically appealing, this option may prove challenging for UK industry in particular where currently invoice finance providers looks at their exposures from the perspective of the seller, considering the likelihood of default and the losses anticipated on default (PD & LGD), a view more akin to the first treatment. Option 3 appears to ignore the role of the seller in the invoice finance relationship, focusing instead on the obligors alone and their likelihood to repay debts on default. We do not support prescription on the use of this approach as it may require a rethink of existing business practices, and the possibility of double counting risk from the seller's-perspective and the obligor's-perspective is high. Overall, we are pleased that the supervisors have gained a deeper understanding into invoice finance and do allow for flexibility.

- Para188q: This provision attempts to impose conditions on the definition of "unduly burdensome" in Annex VII, Part 1, Paragraph 6 of the CRD. Although the first condition is not a problem, the second one might be. The implication of this condition is that we would need to confirm that the underlying obligors (who may not be known) are not our usual customers. If we were providing invoice discounting it is quite possible that some of the underlying obligors are our customers. However, meeting this condition in practice would be almost impossible, and as such the condition should either be re-drafted or deleted.

- Para 188o: We recommend that the guidance make it clear that any concentration limit considered necessary by the firm would be set by the firm, not the supervisor.

Dilution Risk:

- Para 188x: Dilution risk is commonly reflected in the price. The prescribed CRD EL (i.e. PD*LGD) is an unsuited measure to assess materiality, as it already assumes that the risk is material.
- Para 188u: The proposed pro rata treatment of dilution is overly prescriptive and not reflective of the way dilution risk is addressed in ABCP transactions. We recommend this paragraph be deleted.

It is our understanding that the intention of the second sentence of Article VIII, Part 1, paragraph 20 is purely intended to prevent the double counting of receivables exposures (using them as collateral) in the risk weighting of asset backed exposures; i.e. that the risk weighting achieved through the securitisation framework can not be further improved by looking to the underlying pool of assets. We would welcome clarification that this indeed is the case.

3.3.3.2. Loss Given Default

In general we think that the quality of the drafting of the old text in this section in CP10R has been improved. The section on the Discount Rate has been improved and we welcome the flexibility included, with the burden of proof on firms to justify the rate they use. We also appreciate an easing in the language outlining the data requirements, in the allocation of costs, and the estimation of methodologies. However there were some key elements of the original text that we questioned, and which CEBS has not provided any feedback on. For example, we did not agree with the proposed mandatory requirement (Paras 231 – 233) for firms to include incomplete workout cases in estimates of LGD. We still feel that inclusion of the results of incomplete workouts into LGD estimates will result in LGD estimates based on loss estimates, rather than true observed losses. In some circumstances, this may provide the best means of estimating loss, and where this is the case firms should be able to demonstrate that it is appropriate. However, we note that some national regulators in the EU are proposing to allow firms to exclude accounts that cure or are restructured from their default and loss experience, provided they can demonstrate that this does not result in lower capital requirements and strongly urge CEBS to adopt a similar stance. Other detailed comments we ask CEBS to reconsider include:-

Data for economic loss:

- Para 199: The definition of realized loss and loss in LGD definition remains unclear and potentially ambiguous (cf. Para 168). "Realized" has been removed in Para 168 - but the vague loss definition here remains inconsistent with Para 199 (e.g., do fees or workout costs count towards losses or not?)

Estimation methodologies:

- Para 232: "LGD estimates should incorporate the results of incomplete workouts" - this makes little sense in particular for workouts with binary payments, e.g., the liquidation of mortgage loans. Unchanged - CEBS argues that the formulation is

flexible. The requirement: "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" is unclear.

- Para 237: "Use of market prices for defaulted exposures for LGD estimation in case of scarce internal loss data" could enforce the use of likely unrelated information – and we believe this is unacceptable. Although the wording has been improved in the revised paper this is still critical as there remains a risk of conservative misinterpretation at the national level.

Downturn LGDs (new text)

In essence the new paragraphs (Para 219a and 219b, and Paras 239a to 239d) reflect the work of the joint Accord Implementation Group / Capital Task Force and the BCBS publication "Guidance on Paragraph 468 of the Framework Document" (July 2005). However, the clear statements in this Basel paper: "*No material adverse dependencies between default rates and recovery rates have been identified through analysis ..., the LGD estimates may be based on long-run default-weighted averages of observed loss rates or they may be derived from forecasts that do not involve stressing appropriate risk drivers*" we note did not make it into CP10R and should be considered for inclusion. Moreover the statement in Para 239a (1) encouraging supervisors to direct firms "to focus their efforts on types of exposures for which they believe the downturn effect is of special concern" could potentially lead to regulatory arbitrage and will result in the guidelines falling along way short of achieving any consistency in implementation across the EU.

We would further highlight the absurdity of the "downturn" LGD concept by reference to Para 239e, which attempts to explain why downturn LGDs are not to be used in assessing the EL for defaulted exposures, and in doing so presents a very unbalanced view of the principles contained in the BCBS paper.

We would ask CEBS to include explicit wording to the effect that the use of non-downturn LGDs in a firm's internal management processes will not, in itself, be regarded as breaching the use test (Para 239c almost gets us there). We also welcome in Para 239d the reference to the overlap between the downturn conditions assumed for estimating LGD and those adopted in some forms of stress-testing. Where a firm assumes 'stress' and 'downturn' conditions that are similar, we agree that the LGD estimates used might also be similar.

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

We are pleased to be able to review the new material in section 4.3.4 relating to the Advanced Measurement Approaches. But we are disappointed to note that our comments in the joint trade associations response to the original CP have not been reflected either by rewording of existing material or in the approach apparently used to develop the new material.

As stated in our covering letter our fundamental assertion is that CEBS material should be principles based, and seek to promote a harmonised approach to banking supervision by removing opportunities for national regulators to introduce super-equivalent requirements. A prescriptive regulatory framework, as outlined in CP10R, will undermine the key flexibility construct of the AMA, stifle innovation in the OpRisk management and measurement

framework, and restrict OpRisk activity to regulatory compliance rather than best-practice risk management. CEBS should focus on generating a common understanding of the minimum requirement necessary to ensure proper implementation of the CRD and go no further than high level principles.

Furthermore, we believe the guidance CEBS produces in its Consultation Papers should be targeted at informing regulators, not firms, about the implementation of the CRD and thus allowing the development of industry good practice and avoid introducing concepts, requirements or definitions that are new to industry practitioners. We are particularly disturbed that the guidance introduces requirements that are super-equivalent to the CRD and have noted in our response below where we believe this to be the case. Such instances of super-equivalence should be rooted out and, if they cannot be justified on a cost-benefit basis, be removed.

We welcome the acknowledgement that operational risk management is still in its infancy, although it is evolving rapidly. There is a real danger that if regulators create guidance which is centred solely on currently used methodologies – e.g. the Loss Distribution Approach (LDA) or Scenario Based Approach (SBA) — other AMA methodologies may be crowded out before they germinate flower and bear fruit. For instance another commonly used methodology – the Risk Drivers and Controls Approach– is not acknowledged in CP10R. Such focus runs the risk of certain specified methodologies being seen by regulators, auditors and others less expert in the field of operational risk management as the preferred approach. They are not.

Our general concern in relation to CP10R is that the text that was consulted on in 2005 remains too prescriptive. We re-iterate below an important comment from our previous response which requires banks to reconcile operational risk loss data to the general ledger.

Reconciliation to accounting data

We note that Para 445 still requires cross checking of loss data to accounting data and to explain material divergences. We believe this is a requirement to reconcile data to the general ledger but that it is impossible for a number of reasons:

- the use of loss thresholds for data collection
- the embedding of losses in other accounting/cash flow entries by the time it reaches the General Ledger;
- the difficulty of identifying the loss components arising from a loss event – e.g. staff overtime required to sort out an error.

Any approach to the confirmation of data completeness must recognise that firms' ledgers are structured to collect and report information for financial reporting and management accounting purposes and that given the nature of operational losses, a neat mapping of one to the other is not possible. Rather firms should be able to verify that their data is of sufficient completeness and accuracy using a combination of techniques appropriate for that organisation. These techniques may include the assessment of the data collection process or the cross checking of data to other available sources (which in some instances may include the general ledger). Further verification processes are likely to include management sign-off of the loss. These techniques are already used by our members. Reconciliation to the general ledger, however, is not always an appropriate tool and as such is unlikely to be carried out, so the requirement in the last bullet of Para 445 should be removed.

Detailed comments on 4.3.4

In general we find this section (4.3.4) provides far too much detail. It should be substantially slimmed down.

- Para 449a: We agreed that LDA and SBA approaches are commonly used but so are other approaches and more techniques are likely to evolve. We recommend the rewording of the last sentence to:
  "….. be applicable to any AMA approach, either existing or yet to be developed."
- Para 449b: This paragraph should emphasise that examples are offered, but others not mentioned in the text could be equally valid. As some of the definitions in 456 are new and not used by industry we recommend the rewording of this paragraph:
  "… understanding among competent authorities and examples of the definitions and the interpretation of the most commonly used Operational Risk concepts."
- Para 450: The word 'etc' should be deleted as this is not an example.

General criteria on AMA models

- Para 451 and 452: These two paragraphs should be deleted. Paragraph 451 acknowledges that some terms are used interchangeably – this is itself potentially confusing. We would suggest just one term in each case, and prefer 'distribution' and 'figure'.

Combination of the four elements.

- Para 455: Depending on a firm's approach to operational risk it may choose to weight one of the four elements at zero. As long as it can justify this to regulators we believe this is appropriate. We therefore suggested the wording should be amended to:
  "……. how the four elements are weighted and combined ……"

Internal data

- Para 456b to 456h: We are sure that none of the definitions in 456b to 456h are necessary and recommend that they be deleted. Despite CEBS's presumed assumption, these are not descriptions that are recognised by the industry. This will lead to prescription, especially when the proposed definition of a loss event and how to treat it in a model is not based on CRD requirements. Where methodologies cannot be matched to these definitions they are likely to deter the development of alternative approaches. In particular we are insistent that the terms 'rapidly recovered loss event', 'multiple effect losses' and 'near miss event' definitions are removed. These terms are not used in the CRD and should therefore not be introduced in CEBS guidelines. Also, in the case of the 'rapidly recovered losses, this information is of little use to an OpRisk framework, but is a significant burden to capture; the resources required to capture these losses would be much better deployed in real risk management activities.
- Para 456j: This paragraph is confusing – initially referring to insurance policies but then changing to describe a rapidly recovered loss event (RRLE) and introducing a supervisory discretion as to the period of time that should evolve for a RRLE. We

have two concerns with this, firstly the introduction of a supervisory discretion which will create an unlevelled playing field, and secondly the requirement to collect and categorise information on RRLEs. Industry does not routinely collect such information, is not required to do so and does not want to collect data just for the sake of it, at extra expense. All references to RRLEs should be deleted.

- Para 456k: We recommended deletion of this paragraph. Firms should not be told how to treat multiple time losses in their models. Our members are very willing to describe to regulators how they treat such losses but not to be told how to treat them. This is a matter for the institution concerned.
- Para 456l: Unless it is a clear requirement of the CRD, CP10R should not be specifying what should or should not be included in the data set. Some firms may wish to include the absolute value of operational risk gain events where they have been created by a control failure and where they could, had market events been different, have resulted in a loss. This is a decision for the firms to take.
- Para 456p: As 456b emphasises it is entirely up to the firm to set loss collection thresholds. 456p seems to require multiple thresholds depending on the risk and complexity of an operational risk class. This requirement is super-equivalent to the CRD. We recommended the deletion of this paragraph and the following Para 456q.
- Para 456r: This paragraph suggests that a qualitative adjustment should be made to data that is incomplete, which will lead to difficulties about how the model in which the data is used should be validated. 456r could be more briefly re-written as: *'Firms must demonstrate that any bias potentially introduced by the level at which a threshold is set is properly recognised and adjusted for.'*
- Para 456u: These two paragraphs implicitly push firms towards using external data provided by consortia. Not all our members wish to join a data consortium, which is no better or worse than public data. 456w introduces the possibility that public data could also be biased. Additionally 456u introduces a requirement about how institutions that participate in consortia should provide data. This is a matter for the consortia, not regulators, to provide guidance on. We feel that this section improperly prescribes what the 'right' external data is. We recommend the deletion of Paras 456u and 456w.

Scenario analysis

As with other aspects of OpRisk measurement, scenario analysis is still in a phase of rapid evolution. Yet the discussions in CP10R about the number of scenarios a firm should use and their granularity suggest that SBA is more of a science than it really is. Nor are there clearly established statistical tests that would support the number of scenarios to use. We therefore recommend the deletion of para 457a. Although the commentary on SBA techniques is not incorrect it is not needed in CP10R.

AMA four elements: qualitative inputs

- Para 457b: We think the last sentence of this paragraph is helpful to industry as it recognises that it is the firm's decision about how to incorporate BE & ICFs into a model. But the earlier part of the paragraph seems to push firms to use Key Risk Indicators (KRIs), as opposed to self assessment with a subsequent qualitative adjustment being made to the model. In live use by firms BE & ICFs are qualitative modifications to the quantitative output of a model. These modifications should not be prescribed by regulators.

Business Environment and Internal Control Factors

- Para 459: We suggest the rewording of this paragraph to
'…..AMA models that use qualitative data should be reviewed by specialists, and used with particular circumspection and care.'
We have suggested the deletion of the last clause as it implies our members are not already circumspect and careful. They are!
- Para 460: We suggest the removal of the second bullet as it is impossible to demonstrate.

Model input, execution and output

- Para 461c: This section is too focused on the LDA. Para 461c should be deleted.
- Para 461n: This sentence refers to data completeness so should be moved to the Internal data section.

Expected losses, correlation, insurance and other risk transfer mechanisms.

- Para 461v: This section is an example of what can be achieved using a principles-based approach rather than prescription.

Correlation

This section on correlation in relation to operational risk losses sets much higher standards than are required, either in the advanced IRB approaches or the market risk VaR correlations standards, as well as being super-equivalent to the CRD. The regulatory presumption is that events, especially those in the tail, are correlated with a value of +1 or higher. This is a significant change to the regulatory position from discussions that have taken place over the past few years. In contrast, the common agreement in the industry is that correlations between different risk classes are generally very low. The proposed correlation assumptions contradict the empirical experience, industry practice, and the supervisory approaches to other risk classes, and therefore, should be removed.

The tone contained in the paper indicates that the validation standards applied by the regulators will be very high. It is not clear that the regulators have themselves adopted the same validation standards when considering the correlation elements of the IRB, or insist upon the same standards for Market Risk VaR models. An implication is that in order to meet the regulatory validation standards, for correlation between tail events, banks will have to experience more tail events. The suggestion that banks should have more tail events will not be pleasing to line supervisors, nor to the senior management of banks. Further, as banks enhance their management of tail events, then data will become scarcer, making validation more difficult and possibly penalising firms that are improving risk management, through the regulatory imposition of correlations of 1 or higher.

For OpRisk, the combination of an assumed correlation of 1 (or higher) and validation standards could result in the overall capital charge for Operational Risk being the sum of individual risk measures. This increase in the capital charge will reduce the likelihood that banks will use the AMA and instead revert to the Standardised Approach for capital purposes. These same banks may nevertheless continue to use the AMA for economic

capital purposes, thereby increasing the divergence between regulatory and bank approaches to risk management, missing one of the objectives of Basel 2 and the CRD.

CEBS should justify why it believes higher standards than in the IRB or VaR approaches are required for OpRisk and be very wary of unnecessarily raising the bar in these other areas as a result of these AMA requirements.

- Para 462a: We are extremely concerned that the suggestion of the concept of potential super-additivity of risk should be factored into the overall capital charge. We do not believe that this topic has been sufficiently examined to require anything more than is required by the CRD – that is, that the worst possible case position is 100% correlation, resulting in the addition of tail event capital requirements. Until it can be demonstrated that in operational risk terms 1+1>2, straightforward addition should be the worst-case, last-resort assumption. We therefore recommend deletion of the final sentence of this paragraph.
- Para 462c: We do not really understand this paragraph. Replacing 'Structural dependencies' with 'correlation' might help, but we disagree that correlations should be treated only in the input phase. A firm's approach to this issue will be dependent on its particular model. Regulators should not prescribe a particular treatment. We therefore suggest deletion of the words '…. before the modelling phase'.
- Para 462e: This should be deleted and Para 462f reworded as follows:
  "The soundness of dependency assumptions which have a material impact on the overall AMA measure should be demonstrated ………… of stress-tests analyses."
- Para 462h: It is unclear to us why outsourced activities should be excluded from other risk transfer mechanisms. Firms already assess the risk of outsourcing and include it in their models, and we recognise that outsourcing does not completely transfer risk. However, where there are robust centralised obligations between the firm and its outsourcer it should be permitted to include as its event value the gross loss less the value of any recoveries from the outsourcer, in the same way as insurance recoveries would be treated.
- Para 463b: We suggest the merger of this paragraph with 463e, to read…..
  'An institution should have an internal validation process to ensure that elements of its methodology affected by a significant change in its operational risk profile or assumptions are revalidated. The internal validation process should be proportionate and take into account the specific purpose for which the operational risk measurement systems are used.'
- Para 463f: We question how we can demonstrate that information is as accurate and complete as possible. We therefore suggest adding a final clause to this sentence:
  'and as complete as practicable, having regard to its pre-determined cut off levels and the cost and benefits of any such information verification'. (Many things are possible, but few are practicable)
- Para 463j: The requirement that "all" data above the threshold be validated is costly and adds little value to the AMA calculation process. We suggest "data above the threshold should be subject to proportionate validation, taking into account the impact of the data upon the AMA calculation results." We assume that 'constructed' data means external data and recommend that the wording be changed to reflect this. The last sentence should be changed to read 'where external data is used it should be subject to proportionate review and challenge.'
- Para 463m: CEBS's advice to regulators focuses on the calculation of regulatory capital. The reference to economic capital should be deleted.

- Para 463n: This sentence should be deleted. We do not understand how a methodology can be validated until it is built. Model development is an iterative process.
- Para 463o: There is concern that Annex VI will be converted into a regulatory checklist, forcing banks to use techniques that may not be necessary and giving regulators false comfort in a list.
- Para 463q: For the first time in CP10R KRIs are mentioned (although previously alluded to in Para 457b) The reference to KRIs should either be deleted or the word 'might' inserted before the first bullet, to read:
  'These might include verifying that:'
- Para 466: We are surprised that the regulators believe that firms accept operational risk passively. They do not and devote significant resource to mitigating it. We would prefer the deletion of the words 'is taken on passively and'.
- Para 469: We suggest the last two sentences should be reworded as follows
  'The management body should have a general awareness of the AMA framework used by their institution. Senior management may delegate certain tasks but remain responsible for implementing and developing the AMA framework.'
- Para 470: We do not believe it is possible for the management body and senior management to have a detailed comprehension of an operational risk framework's associated management reports. The second sentence should be reworded as follows:
  'They should have a general understanding of how operational risk affects the institution, of the overall operational risk framework and a detailed comprehension of the operational risk management reports presented to them.'
- Para 470: We think that the requirement that the operational risk framework be required to specify levels of acceptable risk is super-equivalent to the CRD. The last bullet point should be deleted.
- Para 474: The 9th bullet point introduces a requirement that senior management (which we take to mean those individuals heading a firm's operational risk team) should assess operational risks in new areas before they are introduced is unrealistic in some cases. For instance it is unlikely that such senior management would be involved at the due diligence stage before an acquisition was completed. We suggest deletion of the wording 'before they are introduced'.
- Para 481: The reference to economic capital should be deleted.
- Para 482: We do not think it is yet possible to back test or benchmark the quantification and allocation processes. This sentence should be re-written as:
  '…, Insurance), where sufficient data is available, benchmarking and/or back testing and …….

Annex V

While we strongly support the statement in the heading that these are a non-exhaustive and non-binding list of examples, we fear they will become very like a checklist in the eyes of users, thus channelling the development of the execution phase of an AMA model. We therefore recommend the deletion of this Annex.

Annex VI:

We recommend the deletion of this Annex for the same reasons as immediately above.

Annex VII:

For the same reasons we prefer deletion of this Annex, or at least the replacement of the first line with the words:

'The following is a non-exhaustive and non-binding list of elements that may represent good practice of the model output.'

Annex VIII:

We believe that the CRD permits addition of risk measurements, implicitly assuming a 100% correlation as strictly a worst case. The last sentence of para 3, referring to the 'science' of non-subadditivity should be deleted.