BELGIAN BANKERS' AND STOCKBROKING FIRMS' ASSOCIATION
Taxation, Accounting Standards and Prudential Regulations Department

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Brussels, 21 February 2006

Dear Sir,

Guidelines on the implementation, validation and assessment of AMA and IRB approaches (revised) : comments of the BBA

The Belgian Bankers' and Stockbroking Firms' Association has the pleasure of sending you its comment on the CEBS CP 10 Revised *Guidelines on the implementation, validation and assessment of Advanced Measurement (AMA) and Internal Ratings Based (IRB) Approaches*. Given the short time for consultation, our comment is focused on the AMA Approach. We also refer to the FBE response on the whole CP 10 Revised document. We fully support the FBE comments.

Please find below a summary of our major remarks.

In spite of the numerous improvements which have been made to the first draft document, we think it is still far too prescriptive – especially for the new sections which have now been included on the quantification of AMA.

We are strongly opposed to paragraph 462a on correlation, which imposes "the overall AMA capital charge as the sum of the individual risk measures only if they ensure that they do not underestimate the dependencies of the tail events". We find this measure much too conservative and not in line with commonly accepted practices regarding the diversification effects for operational risks. Moreover, the simple addition of risk measures implies that in most cases, AMA would become more capital hungry than simpler approaches (TSA, BIA), and this inhibits any incentive to move towards AMA.

We also feel that the use of insurance as a risk mitigant for operational risk has to remain in line with the current market practices. Even though this is formally stated in the Directive, we think that it would be unrealistic to apply a haircut three months before the end of a policy when AMA banks have a clear and well-defined renewal process.

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There are still many inconsistencies in the field of terminology. In our opinion it is of the utmost importance that CEBS adds a separate section with definition of terms, aiming at a common understanding of the used terms. CEBS should accurately review the CP10 Revised to ensure that the appropriate term is used where needed.

Finally, we would appreciate if CEBS could confirm that when an EU parent credit institution and its subsidiaries use AMA on a unified basis (CRD Art. 105.4), the fact that a subsidiary uses BIA or TSA at local level, is not an obstacle as to be part of the "unified basis" at consolidated level and does not change that only one single application is sent to the consolidating supervisor

Our detailed comment can be found in the enclosure to this letter.

We hope this comment will help CEBS in improving the document and in bringing it more into line with the commonly accepted practices regarding operational risk measurement.

Please do not hesitate to contact our services or specialists if you want any further comment.

Yours sincerely,

Daniel Mareels
Director

Didier Andries
Adviser

Guidelines on the implementation, validation and assessment of AMA and IRB approaches (revised): comments of the Belgian Bankers' and Stockbroking Firms' Association, annex

1. Main comments on the document

Although many enhancements have been made vis-à-vis the initial draft of the document, we feel it remains much too prescriptive – especially in sections that have now been included and are new, such as those on quantification of AMA. Moreover these sections refer specifically to LDA-type approaches, while not recognising the existence of other AMA models for which the current level of presciption in CP10 is felt as misplaced. In this context, we feel it of utmost importance that CEBS revisits the text and makes adaptations as those made in this latest CP10 version, subsequent to industry feedback, to the section on the use test for operational risk.

We strongly oppose the paragraph 462a on correlation, which imposes "the overall AMA capital charge as the sum of the individual risk measures only if they ensure that they do not underestimate the dependencies of the tail events". This measure is much too conservative and not in line with commonly accepted practices regarding the diversification effects for operational risks. Moreover, the simple additions of risk measures would imply in most cases that AMA would become more capital hungry than simpler approaches (TSA, BIA), inhibiting any incentive to move towards AMA.

We also feel that the use of insurance as risk mitigant for operational risk has to remain in line with the current market practices. Even though this is formally stated in the Directive, applying a haircut three months prior to the end of a policy when AMA banks have a clear and well-defined renewal process is not realistic. In the extreme case, and following the proposed logic, it would mean a financial institution would need 20% more capital on December 31 (last day of existing policy) vis-à-vis January 1 (first day of new policy). We expect CEBS to provide reasonable and pragmatic principles towards its members on how to deal with these instances.

There are still many inconsistencies in the use of terms. For example, there are significant differences (in interpretation) between the "risk measurement system", "risk measurement framework", risk measurement methodology etc. – and they are used inconsistently throughout the document. It is of the utmost importance that CEBS adds a separate section with definition of terms, aiming at a common understanding of the used terms. CEBS should accurately review the CP10 Revised to ensure that the appropriate term is used where needed.

Furthermore, we would expect CEBS to also clarify which applications are required from financial institutions that will apply different approaches at group level and in subsidiaries.

It is crucial to get a formal validation on the following statements in case of AMA approach:

- **An institution that will apply AMA at group level has not to submit to a host supervisor a separate TSA application for a large subsidiary that will use TSA at the stand-alone level**
  The consolidating supervisor will forward to the host regulator the concerned part of the AMA application.
  We do not follow the rationale enabling to ensure robustness and/or consistency by having at the same time a large (30% of the group) subsidiary applying TSA at the stand-alone level on a permanent basis while we would allow to claim AMA approach at group level.

- **It is up to a banking group to evidence/demonstrate that its internal AMA framework/policy complies with CRD requirements.**

- **It is up to a banking group and eventually to its subsidiaries (or branches) to evidence/demonstrate that local implementation of group AMA framework/policy complies with group ones.**

- **Applying a transitive rule, local implementation of group AMA framework/policy complies with CRD requirements without any other additional evidencing.**

2. Detailed comments

§ 6: The right of each national supervisor to ask for additional documents when assessing an application to use an AMA or IRB approach, or in subsequent examinations or inspections, is contradictory with art. 129.2 of the Directive as well as with the overall goal of the consultation document. As such we strongly oppose such a possibility

§ 23a: Please change the wording 'are free' with 'will refrain from' in the sentence: '*In transposing a Directive, member states are free to impose stricter requirements than those set out in the Directive*', as this harms a uniform implementation of the CRD.

The last bullet should also be rewritten and made more clear. The text implies, for example, that correlations are capital-relief tools, which is not necessarily so. Furthermore, the text also implies that capital-relief tools can only be applied to expected loss, but they are as relevant (or even more so) for unexpected losses.

§ 57, last bullet point but one: 'general information on the institution's <u>IT structure</u>': please explain if this information concerns the IT <u>infrastructure</u> or the <u>IT organisation</u> of the institution?

Put otherwise, does the information on the institution's IT-structure refers to the IT related only to ORM-systems or to the global IT organisation of the entity.

§ 62: Concerning AMA, we find this paragraph too prescriptive and ask for a rewording. Institutions develop one overall common framework on operational risk which is compliant with the CRD, which can be assessed. The self assessment is in practice performed within each institution vis-à-vis the institution's CRD compliant framework and not vis-à-vis the CRD itself.

As such it seems appropriate to refer to the paragraphs 463a and following concerning the internal validation. We also note that paragraph 421 provides national authorities with the possibility to exercise their own assessment.

Concerning a partial use we ask for clarification on the application process. We are of the opinion that only one file should be submitted for the whole institution, including a description of all methods to be used, and not additional application files in host countries for those subsidiaries that will adopt a more basic approach than the group.

Furthermore, we would like to draw the attention to the following points:

- It is up to a banking group to evidence/demonstrate that its internal AMA framework/policy complies with CRD requirements.
- It is up to a banking group and eventually to its subsidiaries (or branches) to evidence/demonstrate that local implementation of group AMA framework/policy complies with group ones.
- Applying a transitive rule, local implementation of group AMA framework/policy complies with CRD requirements without any other additional evidencing

§ 418, table 2: We fail to see the logic as to why the combination LE – TSA with Branch – BIA is not acceptable. In the context of an entity using TSA with a foreign branch that solely performs a commercial activity (rep office), it is impracticable to force this foreign branch to comply with all TSA qualifying criteria, especially the ones around the governance structure. In such case the use of BIA should be allowed.

§ 430: please introduce a difference between a permanent and a temporarily partial use in the roll-out policy, as the phrasing here implies that the roll-out plan will only be completed when all subsidiaries have implemented AMA.

§ 432 '*Institutions should have systems and procedures….*' We are of the opinion that the word 'systems' is not appropriate in this context and should be deleted.

§ 437, principle 1, first bullet point

Please change 'risk measurement system' by 'risk measurement framework'.

§ 442: second bullet point

We find the use of "cross-checking material operational risk data" unfortunate, and ask for a more principle-based rewording. Moreover, the current wording implies that such system for cross-checking exists and is implemented uniformly within the organisation. This is impracticable in some areas like trading where losses are burried in the trading p&l. The wording should be amended to reflect the 'best effort' basis of the reconciliation effort.

The conduct of the review should not be restricted to Internal Audit. In many credit institutions, the review is performed by the independent validation function.

§ 445, last bullet point

We find these examples too prescriptive. Please rephrase as follows: '*Examples of activities aiming to improve the data quality standards could include but are not obligatory* '

For the last bullet, please see comments on parag. 442.

§ 448, first bullet point

We find this wording too prescriptive. Please rephrase as follows: '*Examples could include but are not obligatory:* '

We also find the use of the term "provide" in the first sentence unclear: is this documentation required as part of the application, available at any moment upon demand by the regulator,…?

Please also eliminate the bullet related to "filters used to create and debug the database". We feel that this goes even beyond good practice.

§ 449a: We prefer a more principle based approach for these guidelines. As such we are of the opinion that this description is too much focused on an LDA-approach.

§ 450: We propose to add '*Cause*' as an operational risk class.

§ 455: Please explain what is meant with the last sentence of this paragraph and a '*chain of processes' in particular*?

§ 456, second bullet point: this text should be completely rewritten as it is unclear what is meant by it.

§ 456b: We are of the opinion that this description is too much focused on an LDA-approach. Please change the wording '*calculation data set*' into '*data set'*.

§ 456j: In this paragraph two issues are mixed (use of insurance on the one hand and loss ies – which can be in a different way than through insurance coverage - data recovery on the other hand) which makes it impossible to understand. As such, we ask that this section is reworded .

One must appreciate that recoveries stemming from insurance policies require in most cases that a claim is entered with the insurance broker/underwriter, and that it is thus debatable whether such recoveries can be obtained in a short time limit.

Furthermore, clarification should be provided as to the reasoning why rapidly recovered loss events must be treated differently than loss events that are recovered over a longer period. In any case, the definition of a "short time period" must be interpreted with significant flexibility, or will lead to the situation whereby recoveries that occur 1 day later than the set deadline must be handled differently.

§ 456n, last bullet point: We find this wording too prescriptive and ask to reword it. In addition, the last sentence only creates confusion, and should be deleted: it may lead to an interpretation where such losses are double counted.

§ 456p: We do not agree with the wording 'setting the treshold requires <u>accuracy</u>'. The term "accuracy" is totally misplaced int his context, as there is inherent inaccuracy in setting a threshold.

§ 456v: We note that the ORX-database does contain significant information on tail events, and thus recommend that for clarity purposes .

§ 456x: We find this wording too prescriptive as 'size' is not the first word "where" is replaced by "in those cases where"., and ask for a rewording that is more principle-based. We also point to the fact that may not be best proxy to adjust the scaling of the data, and thus request that reference to any specific scaling factor is deleted. Every organization must define how it will scale data, and convince the appropriate regulators of the appropriateness of it scaling methodology.

§ 457a, second bullet point: We note that this requirement cannot be applied. The statistical data to support such a requirement is simply not available.

§ 457b – e: this section has been written in too prescriptive a manner, and implies that organizations must implement Key Risk Indicators, even thought the term is not used. Here again, rewording is required and principles must be introduced to reflect more appropriately the broader concept behind 'business environment and internal control factors'. This sould encompass KRI techniques but also techniques factoring in the quality of the control environment within the estimates entering the model. Moreover, adjustments to the estimate can be done ex-post, as a scalor on the model output, or ex-ante, as a tuning of the estimates entering the model.

§459 – this paragraph is meaningless and should be deleted. It implies that AMA models that use quantitative data should not be built by specialist, and not be used with care.

§ 460: Please replace the wording '<u>should</u> be able to demonstrate' with '<u>can for example</u> demonstrate'. Reasons:

a) second bullet point: it is impossible to remove biases in chosing data; in addition, stating that "everything possible" must be done, in "all" business lines and geographical locations is not a realistic requirement, that in addition can be interpreted very subjectively.

b) last bullet point: we recommend that this is reworded and that better terms are used. For example, wonder how a correlation between a certain score and fraud losses can be demonstrated, when data is insufficiently available.

§ 461c: We are of the opinion that this paragraph is flawed, and makes certain assumptions that are inherently wrong. Whereas one should strive to create homogeneous risk classes, it is impossible to have full independence between loss events in a risk class. Furthermore, it may not be optimal to always have these loss events identically distributed, and more accurate to use other assumptions..

§ 461g: We strongly feel that, here again, the use of the term 'accuracy' is misplaced. Given that AMA requires to measure something that can not be accurately measured, it is not realistic to require institutions to define accuracy numbers. This is even more the case given that further paragraphs (e.g. 461q) permit the use of methodologies that almost by definition prevent one from defining correct error margins – and thus to set an accuracy range.

§ 461j: This paragraph should provide more details on whether scaling up or scaling down – or both – is permitted.

§ 461l: We are of the opinion that this description is too much focused on an LDA-approach. For this reason we ask to replace the words '<u>may need</u>' by '<u>may benefit from</u>'.

§ 461v, point 1: 'the institution should be able to demonstrate that the corresponding losses are <u>highly</u> predictable…'

The word 'highly' should be deleted as otherwise not practicable in for example the context of the budgeting exercise of expected loss. Although predictable, OR losses will never be highly predictable. OR is not an exact science.

461y: please change "built on a set of loss events and loss amounts that are" into "built on a set of loss events and loss amounts **(actual or constructed)** that are"

§ 462a, last phrase: We request to delete this phrase, as it is too contentious and based upon specific theoretical views on operational risk quantification. Overall, we feel that this paragraph is too much guiding towards the use of EVT and specific LDA models, which is contrary to the approach taken by that Basel Committee to grant institutions the freedom and flexibility to determine their own quantification methodologies.

§ 462c: we find the use of the term "structural dependencies" very unclear and confusing, and fear that it will lead to different interpretations. We request that this praragraph is significantly rewritten, and that principles are established.

§ 462g: We find this wording confusing, as there are not an agreed level of standards defined for the recognition of insurance. Moreover, CEBS should establish principle based guidelines on how insurance can be used as a true risk mitigant, without the need to apply haircuts in case financial institutions have a clear process to renew insurance policies.

Moreover, applying same standards to other risk transfer mechanisms may just inhibit any initiative for the industry to develop them.

Sections 4.3.4.5: we ask that this whole section is reviewed and that redundancies are eliminated. We find that the differences between the validation of risk measurement systems and risk management processes, and the validation described in paragraphs 463a-d is unclear. This leads to a confusing view on what validation is required, and when it is required.

§ 463b, point 5: We propose to rewrite this to address the situation where the internal validation is performed by internal audit, as the current text then would require another independent group to review the internal review which has already been done by an independent party.

We think that the independent review can be done by a Risk Management/Capital Validation Measurement team and not directly by the internal audit (audit can intervene in a 2nd level).

§ 463d: this paragraph is confusing and does not specify whether ongoing validation of the validation methodology or of the risk measurement system is required.

§ 463j: We are of the opinion that it is impossible to construct assumptions that are unbiased. As such that cannot be "ensured". We thus ask to rephrase this.

§ 463k: We wonder what is meant with the word 'ultimately'? We ask to delete it.

§ 463q: We find this wording too prescriptive and propose to replace the words 'These include..' with 'These can include…' In any case, we think requiring that KRI's and the compliance reports are in line with the results of qualitative self-assessments is too stringent.

We agree with the proposal of CEBS to backtest the qualitative self-assessment outcomes thanks to KRI's: the self-assessment outcomes must highlight the largest risks for an entity, and KRI must be set up aiming to measure these key risks. If the KRIs are always green (= under control), are the risks as high as assessed? If the KRIs are always red for risks assessed as not high, were the risks properly assessed?

§ 464: Under the assumption that 462a remains of application, we feel strongly that a formal allocation may not be required if one calculates the overall capital requirement by summing stand-alone capital requirements. In such cases, the composition of the capital number is itself already an allocation, and formalizing an allocation adds no value.

§ 470, second phrase: 'They should have a general understanding of the institution's operational risk measurement systems....'. Please change the word 'systems' with 'framework'.

§ 471, last phrase. We are of the opinion that the costs and benefits related to the implementation of an AMA-approach are internal figures which need not to be transferred to the regulator.As such we ask the deletion of this requirement.

§ 481: we find this paragraph too prescriptive and ask that it be deleted.

Annex IV, V, VI and VII: we find that these are too prescriptive and too much determined by a single view on how AMA capital requirements must be calculated. We strongly recommend to delete these.