European Banking Federation
Secretary General

N°0145-2009
NF/AH

Email

Kerstin Af JOCHNICK
Chairwoman
Committee of European Banking Supervisors

Cp21@c-ebs.org

Brussels, 27 March 2009

Subject: ***EBF response to CEBS Consultation on its Compendium of Supplementary Guidelines on Implementation Issues of Operational Risk***

Dear Mrs Af Jochnick,

The European Banking Federation[1] welcomes the opportunity to respond to CEBS' consultative document "*Compendium of Supplementary Guidelines on Implementation Issues of Operational Risk*".

We support CEBS' initiative to clarify certain issues, notably definitions, and provide more guidance on others in light of banks' and supervisors' experience so far in building operational risk frameworks with a view to increasing the convergence of supervisory practices and consistency within and across banks. In that respect, as far as AMA firms are concerned, we wish to underline that home and host supervisors need to adopt a practical approach on capital allocation that reflects the group-wide model and diversification benefits.

We generally find the clarifications of the scope of operational risk (and that of strategic risk) helpful. We nevertheless feel that it could be clarified further to ensure consistent understandings across the supervisory and banking communities as well as to better reflect banks' practices.

As regards the scope of operational risk and operational risk loss, in particular, more guidance would be necessary on how to treat 'pipeline' events, and whether the IFRS framework could be used as benchmark to that effect.

[1] Set up in 1960, the European Banking Federation is the voice of the European banking sector (EU & EFTA countries). The EBF represents the interests of some 5000 European banks: large and small, wholesale and retail, local and cross-border financial institutions.

a.i.s.b.l.

10 rue Montoyer B- 1000 Brussels
+32 (0)2 508 37 11 phone
+32 (0)2 511 23 28 fax
http://www.ebf-fbe.eu

Our detailed comments are enclosed. For any questions, please do not hesitate to contact either myself or my colleague Noémie Francheterre (n.francheterre@ebf-fbe.eu).

Yours sincerely,

Guido RAVOET

Enclosure: 1 (D0300D-2009)

D0300D
Brussels, 27 March 2009

EBF response to CEBS Consultation on its Compendium of Supplementary Guidelines on Implementation Issues of Operational Risk (CP 21)

General remarks

1. The EBF welcomes the initiative taken by CEBS to clarify issues surrounding the implementation of the operational risk framework. In particular, the EBF **strongly supports the stated objective of increasing the convergence of supervisory practices** and the consistency within and across banks in that area.

2. As CEBS rightly states, the management of operational risk is a recent and evolutionary practice. It is therefore **important to maintain the flexibility provided by the Capital Requirements Directive (CRD) not to hinder future developments** in that area. In a number of cases, the Federation considers that a range of practices approach would be more appropriate than detailed guidance, e.g. modelling techniques including correlation, as the higher level principles of the CRD are sufficient to allow for flexibility of approach.

3. The **clearer line between different types of risks is an improvement**. The EBF regrets that CEBS has excluded the issues related to the interpretation of operational risk versus **credit risk** in its guidelines, which would have been very useful. Likewise, although reputational risk should be excluded from the scope of operational risk consistently with the Basel II Accord, some guidance on how to treat **reputational risk** vis-à-vis operational risk would be helpful.

4. The EBF notes that ‘pipeline’ events have not been addressed by CEBS and would strongly **encourage CEBS to provide guidance on how such ‘pipeline’ events should be treated** within the scope of operational risk loss. The accounting rules could provide a helpful benchmark in that respect.

5. **The priority for operational risk management is to capture actual risk events, which impact the Profit & Loss account (P&L).** The capturing of “pending losses”, “near miss events”, “operational risk profit/gains” and “opportunity costs/lost revenues” may reflect sound practice, but are not of the same priority as direct losses. In application of the proportionality principle, EBF Members would therefore expect that the same data quality standards of completeness and loss evaluation should not apply to the latter.

6. The EBF finally wishes to refer CEBS to **Reporting Standards issued by European Consortiums** such as the Operational Riskdata eXchange Association’s (ORX)[1] and the Italian Database for Operational Risk Losses (DIPO). These Standards have emerged from industry best practices over the past years and continue to be developed. They **may serve as a starting point to foster consistent operational risk definitions and terminology** to be used by industry and supervisors.

---

[1] www.orx.org/reporting/

a.i.s.b.l.
10 rue Montoyer B- 1000 Brussels
+32 (0)2 508 37 11 phone
+32 (0)2 511 23 28 fax
http://www.ebf-fbe.eu

Detailed remarks

"Guidelines on the scope of operational risk and operational risk loss"

7. Guidance on definition issues is very useful. The EBF appreciates that CEBS is seeking industry feedback on such issues, in particular loss data consortiums where considerable focus and time is spent on clarifying definitional issues.

8. In order to implement the proposed guidelines in a proper way, the scope of operational risk loss needs to be clarified. Specifically, as stated above (§5), additional guidance would be useful to indicate at what stage certain pipeline events should fall within the scope of the operational risk framework and how potential losses are to be evaluated for each stage[2]. The IFRS framework, which establishes different stages ('probable loss', 'remote loss' …) to calculate different amounts of loss respectively, could provide useful guidance on how to address these operational risks which are still in the pipeline. Minimum requirements to estimate potential losses in each of the possible stages would be appreciated and very useful. By means of example, if a loss is required to be recorded in the financial statement (either as a cash payment or reserve estimate), then this should be an operational risk event.

9. In many cases the devil is often in the detail when deciding how to treat a specific circumstance and attempts at clarification can sometimes be unclear and create further questions.
   For example the definition under paragraph 18, point A of "losses relating to operational risk events triggered by legal settlements" is very unclear[3]. A specific example, whether of a publicly known event or a hypothetical example, would be useful to clarify what is meant.

10. Paragraph 12: it is not clear why CEBS does not wish to include the issues related to the interpretation of operational risk versus credit[4] risk (and reputational risk although it is acknowledged that Basel 2 excludes it) in its guidelines; the EBF believes that it would be very useful.

11. Paragraph 16, point C: We recommend rephrasing the last section to clarify that this refers to a risk-taking "process" (i.e. lack of procedure required by regulation) and not a risk-taking "decision" as follows:

    "Gains/losses due to a wrong selection of the model, made outside a defined business process/formalised procedure and lacking a formalized conscious risk-taking process";

12. Paragraph 17: it is not clear how to manage "the loss due to adverse market conditions" within the scope of operational risk loss. It would indeed at this stage not be practicable to single out the adverse market condition-part of the loss for the four types of events listed in paragraph 16. This part should be removed or more concrete guidance provided. By means

[2] See DIPO's Effective Gross Loss definition in the ABI-DIPO position paper
[3] See DIPO's legal risk document in the ABI – DIPO Position Paper
[4] See DIPO's credit boundary treatments in the ABI-DIPO position paper

of example, please note that the ORX definition includes only adverse movements at time of detection[5].

As acknowledged by CEBS at its public hearing on 10 March, it should be clarified that the amount of the loss needs to be proportionate and related only to the event which has occurred (the failure, the error, the fraud…), upon discovery. If the bank chooses not to close the position immediately, this is not an operational risk, but a market or business one. This item must be stressed to allow banks the freedom to take the best course of action.

<u>Table *'Examples to be included in the scope of operational risk'* (p. 9):</u>

13. Fifth bullet under "Due to operational errors" - It should be better defined what kind of losses are included as "technical unavailability of access to the market (e.g. system down)". For instance, losses which result from the impossibility to close existing contracts for financial products (e.g. derivatives) should be included in this category. However, those events which refer to mere intentions to operate during a system down period should not.

14. Both bullets under "Due to failures in internal controls" need to be revised to become clear operational risk examples.

    For instance the example "market positions taken in excess of limits" should state that this happened unauthorised or by accident and was not intended, i.e. it is outside the formal procedure for exceeding limits. Otherwise it is misleading.

3.2. Operational risk versus strategic risk

<u>Table *'Examples to be included in the scope of operational risk'* (p. 10-11)</u>:

15. "Expenses stemming from law cases or from interpretations of the regulations which proved to go against corporate practice" (second bullet): the words 'corporate practice' should be replaced by 'industry practice' as corporate practices are neither governed nor supported by internal corporate documents.

16. When considering the treatment of "Compensation paid to employees" (third bullet) in the scope of operational risk it needs to be taken into account that social legislations in Europe differ across Member States and therefore that in some cases, it would not be an operational risk issue. For instance, some types of compensations, such as compensation linked to early retirement incentives and extra compensation in the case of an employee's resignation are a firm's own decision and are not related to avoiding losses due to legal risk, they are therefore not related to operational risk. Moreover, different legal regimes on resignation amounts (either established via a specific formula, freely negotiable or legally fixed) should be considered when examining compensation paid to employees from an operational risk perspective.

[5] http://www.orx.org/lib/dam/1000/ORRS-Feb-07.pdf

17. Furthermore, in this paragraph it is implicitly stated that a refund made to a customer by a firm prior to the customer filing a complaint should be considered as operational risk. This, however, does not recognise the firm's autonomous decision-making. The firm may indeed decide to refund a customer for purely business reasons, to avoid losing them or acquiring a bad reputation.

    For all these reasons, the EBF considers that that example should be amended as follows:

    > ~~"Compensation paid to employees and~~ refunds to customers ~~before they can lodge a complaint~~ but, for example, after the firm has already been required to refund other customers for the same event;"

***The events (and the related losses) described below should be included in the "scope of strategic risk"* (p.11)**

18. The clarification of what represents strategic risk is helpful particularly in the context of conducting top-down risk assessments with senior management. In addition to what is defined under Pillar 2, it has proved concretely useful[6] to split strategic risk into two subcategories as follows:

    i. Business/commercial risk, i.e. the risk related to fluctuations of profits/margins compared to the expected data and which is not associated to other risk factors (e.g. interest rates), but to the volatility of volumes or alterations in the tastes of clientele; such risk can be measured and refers to an operational context based on an unvaried strategy.

    ii. "Pure" strategic risk: this is associated with phenomena with a strong business discontinuity from the main strategic choices initially adopted, e.g. entrance into new markets or the adoption of operational choices that are extremely different from the ones pursued so far.

19. Confirmation would be welcomed that the events included in 'scope of strategic risk' are distinct from operational risk and hence not to be included in operational risk but reported elsewhere under strategic risk.

20. The EBF considers that the guideline should clarify how to handle customer complaints without breaching any rules, regulations or ethical conduct. The following modification is suggested:

    > "Losses incurred by the firm as a result of inappropriate strategic/senior management decisions or business choices which do not breach any rules, regulations, or ethical conduct**,** <u>and which are not triggered by legal risk</u>**.**"

    Strategic risk would consequently include customer refunds but only when the related events would not be connected to any breach of rules, regulations, or ethical conduct. This is moreover consistent with what is already reported in the previous paragraph 18 point A.

[6] See White Paper on Pillar 2 from ABI and PwC, Bancaria Editrice 2008

<u>Table *'Examples to be included in the scope of strategic risk'* (p. 11)</u>

21. "Losses relating to decisions made by the competent decision-making body which are not compatible with the firm's risk tolerance level and deviate from its core business activities" (second bullet point) are a strategic risk to the extent that those decisions are made by the competent decision-makers. However, should the loss be related to a breach of a formalized procedure ("risk tolerance level"), then it should be included in the scope of operational risk and excluded from strategic risk.

22. <u>Reputational risk</u>: In reality banks find it difficult to completely de-couple reputational risk from operational risk. Guidance from CEBS on what is excluded as reputational (and credit) risk from the scope of operational risk events would be welcomed. EBF Members wonder for instance whether banks are expected to have a separate framework for reputational risk. The development of industry best practice guidelines on reputational (and credit) risk would be a significant and welcome addition.

4. The scope of "operational risk loss"

23. From a general perspective the EBF finds the table and commentary relating to '*Type of Elements/Items that can result from an Operational Risk Event*' useful as it helps the assessment of internal procedures.

24. Clarification would be helpful on:
    - How to treat events with boundaries between operational, market and credit risks for the calculation of the minimum regulatory capital and to consider them within the scope of operational loss in the Loss Database;
    - Whether the Loss Database should contain also the extraordinary gains and not only the losses.

25. <u>Paragraphs 20, 21 and 22</u>: CEBS' definition of "pending losses" in footnote 8 is vague and not sustainable from an operational risk perspective[7]. Likewise, the concrete meaning of "<u>expected</u> to have a <u>high</u> impact" (paragraph 22) is not clear.

26. In practice, losses need not be specifically classified as "operational" on the books of the firm to be reportable. Clearly defined criteria are necessary to define "pending losses" and to determine at what stage they should be included in the scope of operational risk loss (see also paragraph 9 above). As long as those essential criteria have not been clarified pending

[7] The mere monitoring of the huge amount of transitory and/or suspense accounts could create several problems. For instance, what if a scenario is included in the scope of operational risk losses and then the related transitory item turns into a concrete loss in the P&L? Should the scenario be eliminated from the dataset of CaR calculation in order to avoid double counting?
Furthermore, problems of stability of AMA estimation due to natural unavoidable fluctuations in pending losses and of internal consistency can occur in quantifying the scenarios since transitory and suspense accounts are by definition losses with uncertain amounts and process owners (for example accounting and legal) do not have the elements to provide an estimation (otherwise they would have booked related items in the P&L as provisions and not as suspense accounts). As a consequence, it would be very difficult to receive impact quantification.

losses should not be included in the operational risk loss database. They should only be monitored and tracked.

27. Once it will be possible to clearly identify pending loss from operational risk events, the loss will be considered in the operational risk calculation and used for management reporting and for day-to-day risk management activities.

28. Paragraph 21: A flexible approach is necessary here to take into account that some firms include gains for risk management purposes, but not for capital calculation while others do both.

29. Paragraph 23, first bullet: this needs to be modified to take into account that these triggers should be recognised within the risk management process instead of systematically collecting them in the loss database.

30. Paragraph 23, second bullet: the part where the timing impact is divided into temporary and permanent distortions is unclear. The EBF believes that all the "timing impacts" should be excluded from the CaR calculation (not only those which cause a clear temporary distortion of P&L), because they rectify accounting positions regarding previous periods but they are not proper operational risk losses.

“Guidelines on the use test for AMA firms”

31. The use test should be a key focus for operational risk management. CEBS’ guidelines on the use test are sensible and consistent with banks’ experiences. Experience shows that AMA banks can relate to it. Moreover, the guidance is also useful for other banks which may seek to obtain AMA status in the future.

32. Simpler solutions for smaller credit institutions operating in local, domestic environment and conditions may perhaps be provided.

    Operational risk management in such banks could for instance be based on key risk areas identification rather than on day-to-day observations of business process. Typical key areas of operational risk are connected with information systems activities, security management, human resources management, operations correctness, etc. In that case, well organized and controlled management of unexpected loss and business continuity should be an adequate way for AMA implementation. Analysis of risk profiles and subsequent identification of key risk areas in smaller banks is considered an efficient method for recognizing main operational threats and calculating adequate capital requirements by AMA.

33. <u>Paragraph 10 second bullet</u>: ‘operational risk exposure’ has not been used so far in the financial services industry; it should be either defined or the term ‘exposure’ deleted from this sentence.

34. <u>Paragraph 11, last bullet</u>: this should be deleted as it is impossible to define. There is no marginal business measure for operational risk. Banks have inherent operational risks in doing business and are constantly trying to reduce it to as low as possible, if not zero. Operational risk cannot be measured and monitored in the same way as financial risk and, as such, there are different ways of considering risk appetite for operational risk.

35. <u>Paragraph 13</u>: A certain degree of realism should be ensured with respect to the extent in which senior management can be involved in operational risk. The wording should therefore be amended to allow a more appropriate frequency as follows:

    > “It is therefore imperative that senior management be ~~constantly~~ <u>regularly / periodically</u> updated on the operational risk framework, including its strengths and weaknesses...”

36. The EBF strongly encourages CEBS to update the present guidelines when more experience is gathered on the implementation of TSA/ASA requirements as stated in paragraph 24. Such guidance is key for Standardised Approach firms which are expected to explain the requirements of Annex X, Part 2, Section 4, paragraph 12(b) as acknowledged in paragraphs 22, 23 and 24.

“Guidelines on the allocation of the AMA capital”

37. Home and host supervisors need to adopt a practical approach on allocation which reflects the group-wide model and diversification benefits so that it is not too burdensome for a bank to implement.

38. Paragraph 5: Footnotes should be included to explain the methodologies referred to, i.e. Expected Shortfall, Shapley method etc.

39. Paragraph 10: the need for additional requirements on subsidiaries should be assessed via the Pillar 2 process, without affecting the group wide model.

40. Paragraph 15, in combination with paragraphs 13 and 14: The exact procedure (and necessity) to obtain approval for a new allocation mechanism is not clear, especially the procedure to arrive at a joint decision by home and host supervisors.

41. Experience has shown that the actual debate between home and host supervisors is not always transparent vis-à-vis the bank concerned especially in the absence of a joint decision. This can create difficulties for the bank and result in the holding of additional capital. Regular dialogues within Pillar 2 should take place between the college of supervisors and the bank to avoid such situation.

* * *