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The Director General delegate

Paris, March 31st 2009

Compendium of supplementary guidelines on implementation of operational risk

Dear Madam,

We thank you for inviting us to comment on the consultation of the Committee of European Banking Supervisors «Compendium of supplementary guidelines on implementation of operational risk» issued in December 2008.

The French Banking Federation (FBF) is the professional body representing over 500 commercial, cooperative and mutual banks operating in France. It includes both French and foreign-based organizations.

We acknowledge that the proposed guidelines are helpful in many areas and provide useful clarifications on the implementation of the Guidelines GL 10 on Advanced Measurement and Internal Rating Based Approaches issued in April 2006 by the CEBS. We regret that this clarification was published as late as it has not permitted banks to implement AMA methodology in a swift and consistent manner.

The clearer line between the different types of risks represents an improvement especially for market risks and operational risks. Nevertheless, we think that this document requires more guidance on some issues from CEBS as the definition of "near misses", pending profits or timing impacts.

In addition, a few points of the consultative document can be improved, which we comment in the appendix.

The French Banking Federation wants to see the instigation of healthy competitive conditions and believes the only way to do so is to establish appropriate regulations. The FBF remains at the Committee of European Banking Supervisors' disposal for any further discussion on these matters.

Yours faithfully,

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Appendix – FBF detailed comments (in italics)

Compendium of supplementary guidelines on implementation of operational risk

Guidelines on the scope of operational risk and operational risk loss

Paragraph 4

4. In particular, due to legal considerations, the CRD gives a positive definition of operational risk, the consequence being that it is silent with respect to strategic and reputational risks; risks that are explicitly excluded from the scope of operational risk in the Basel II Accord framework3. Despite such differences in the texts, the definition of operational risk within the CRD should be read consistently with that of the Basel Accord, meaning that reputational and strategic risks should be excluded from the scope of operational risk4.

In reality banks find it difficult to completely distinguish between reputational risk and operational risk as they may be intertwined. Guidance from CEBS on what is excluded as reputational (and credit) risk from the scope of operational risk events would be welcomed. But banks should keep some flexibility

…/…

Paragraph 5

On the other hand the CRD explicitly includes legal risk - as the Basel II Accord does - in the definition of operational risk and this should include every type of legal event triggered by operational risk, regardless of how it is labelled (e.g. compliance risk, environmental risk).

Environmental risk should be more clearly defined.

Paragraph 17

…/… - erroneous evaluation of a position due to a failure in updating prices or to wrong attribution of its parameters.

It should be made clearer whether it includes mismarking due to wrong parametisation in pricing model.

…/…

The events (and the related losses) described below should be excluded from the "scope of operational risk":

Losses due to *wrong selection of a model* made through a formalized corporate process where the pros and cons of the model itself are carefully weighed up.

It is unclear what the "selection" of a model is.

…/…

Examples of cases to be excluded from the "scope of operational risk": *Due to model risk:* - losses caused by a pricing model where the potential exposure to the model risk had been previously assessed, including by considering potential adjustments to "mark-to-market" transactions.

It is also unclear.

…/…

3.2. Operational risk versus strategic risk

Paragraph 18

…/…

Examples to be included in the "scope of strategic risk": - losses relating to flawed investment choices in <u>merger/acquisitions</u>, organizational/management restructuring,

More guidance should be provided by CEBS to exclude errors or fraud on due diligence.

…/…

- losses relating to decisions made by the <u>competent decision making body</u> which are not compatible with the firm's risk tolerance level and deviate from its core business activities;

More guidance should be provided by CEBS to define the competent decision making body and state if properly escalated.

…/…

Paragraph 20

Type of elements/items that can result from an operational risk event
1. Direct charges to P&L and write- downs

We suggest adding "including through equity"

…/…

Paragraph 21

The 1st, 2nd, 3rd and 4th elements/items should be included in the scope of operational risk loss for management and measurement purposes

What about 7^{th} element "Opportunity costs/lost revenues"? It is not clear if it should be included or not in the scope of operational risk loss for measurement purposes.
As the 7^{th} element is not specified in the Paragraph 21, we could understand it should not be included for measurement purposes. If this understanding is the good one, it goes against what has been asked to French banks by the French regulator (Commission Bancaire).

We understand that "measurement" mainly consists in capital calculation. Conversly: are 5^{th} and 8^{th} elements explicitly excluded from regulatory capital calculation?
In addition, do the same rules apply to both historical incidents and scenarios, as far as measurement is concerned?

.../...

Paragraph 23

Moreover:
The "near misses", "operational risk profits/gains" and "opportunity costs/lost revenues" are – after operational risk losses – also important for promptly detecting failures/errors in processes or internal control systems. Accordingly, it is sound practice to develop criteria and procedures for collecting such items.

A definition of a "near miss" should be included : this definition could be "a near-miss is an operational risk event (resulting from failed or inadequate process ...) which results in no financial impact thanks to favorable circumstances (by chance, or following any action taken by counterparty or a third party). The fact that there is no financial impact is neither due to the efficiency of controls nor to a specific internal action. "

The exclusion of the "timing impacts" from the scope of operational risk losses should be limited to those losses which cause a clear temporary distortion of the P&L. All the losses – whether or not labelled as "timing impacts" – that produce a substantial permanent distortion of the P&L (e.g. losses caused by legal risks; see for instance the examples in the first box in section 3.2) should be included in the scope of operational risk loss for management and measurement purposes.

The exclusion of the "timing impacts" from the scope of operational risk losses should not be limited to those losses which cause a clear temporary distortion of the "P&L". For us, the "timing impacts" should always be excluded from the scope of operational risk losses.

Guidelines on the allocation of the AMA capital

3. Assessments of allocation mechanisms

Paragraph 10. The implementation of more risk-sensitive allocation mechanisms at local level could be a way to provide comfort to host supervisors on the appropriateness of the capital figures. One of the main issues is that, as diversification effects are generally determined on a consolidated basis and allocation mechanisms act on the already diversified capital, capital figures allocated to some subsidiaries may not reflect in an appropriate way the actual operational risk and contribution of such subsidiaries to the diversified consolidated capital. This may result in some supervisors imposing supplementary requirements on subsidiaries.

We think that CEBS should devise more explicit rules.

4. Home-host issues regarding allocation mechanisms

Paragraph 13. In the case of cross border banking groups, the use of an allocation mechanism is subject to the approval of both the home supervisor and host supervisors and has to be addressed within the joint decision on the AMA application. Relevant host supervisors are all the supervisory authorities within the EU which supervise subsidiaries whose capital requirements are calculated (or included in the roll-out plan) according to the AMA adopted by a banking group located in another Member State.

We require more coordination between EU supervisors, or a common set of rules, or one single validation process. Cross border banks should not have to do twice the same job (costs/ time spent). The role played by College of Supervisors should be enlarged to facilitate the approval process and to ensure consistency.