

**IIF Working Groups on Capital Adequacy and
Operational Risk**
October 28, 2005

Institute of
International
Finance, Inc.



**Comments on CP10 “Guidelines on the Implementation, Validation and
Assessment of Advanced Measurement (AMA) and Internal Ratings
Based (IRB) Approaches”**

I. General Comments

The Institute of International Finance (IIF) has been involved in dialogue on global capital adequacy standards with the Basel Committee and its subgroups since the beginning of the “Basel II” process. The Institute’s membership includes firms from all major developed and emerging markets, among which are a substantial number of major European institutions. Given its international vocation, the Institute does not propose to comment in detail on all the specific provisions contained in Consultation Paper 10 (CP 10). On this occasion, the IIF will provide comments through its Working Group on Capital Adequacy (WGCA) and Working Group on Operational Risk (WGOR), collectively referred to as Working Groups (WG).

The WG are generally supportive of the comments presented jointly by ISDA, LIBA and the BBA. However, they wish to underscore points of importance to internationally active firms. The WG salute CEBS’s well developed consultation process, and hope to contribute constructively to the ongoing dialogue. IIF members are appreciative of the fact that CP 10 provides substantially improved transparency on supervisors’ objectives, concerns, expectations and approaches to advanced models issues. The IIF also continues to attach the highest importance to clear and reasonable understandings between home and host supervisors. The avoidance of duplication and inconsistency is essential to effective implementation of the CRD and the Institute commends CEBS for the efforts in that direction.

IIF members believe that the final draft of CP10 will be most beneficial if it can stimulate a generalization of open and flexible dialogue that already exists in some jurisdictions; provide clarity of expectations and procedures among supervisors; and provide recognition of the legitimacy of variation in banks’ approaches, subject to appropriately rigorous supervisory review of the outputs of bank-developed structures, models, policies and procedures.

Cross-border Implications, Home/Host Issues: As already indicated in previous IIF responses to CEBS consultative papers, IIF members are particularly interested in the actual achievement of the Basel Committee’s goal of a global level playing field. It is important that CEBS’s guidance be, to the extent possible, in line with similar guidance and regulatory practice being established by international regulatory bodies (such as the AIG) and other regional and national regulators. To maintain the flexibility necessary to ensure consistent cross-border implementation and to minimize the complexity of home-host issues for internationally active banks, CEBS should work to achieve principles-based requirements that avoid any undue prescriptiveness. This will also be useful for the many third-country supervisors that will look to CEBS’s leading example when developing their own implementation guidance and standards.

Furthermore, CEBS should recognize that despite the precise scope of its legal mandate, its guidance will not only be applied to banks with operations limited to the EU but, to a large extent, to banks with truly global operations. This fact underscores the importance of refining CP 10 with

a view toward making consistent cross-border implementation achievable both within and outside of the EU.

In this and other consultative papers, CEBS has made a contribution to the understanding of home/host relationships and issues. While this has of course been driven in part by the requirements of the CRD and other EU directives, it will nonetheless have wider resonance. To summarize a viewpoint more fully developed in discussions with the AIG and elsewhere, the Institute supports development of clear guidelines for exchange of information and allocation of responsibilities between home and host supervisors. While the legal obligations of hosts must of course be respected, the reality is that Basel II and the CRD will only be effective if coherently implemented across borders without duplications, inconsistencies or unnecessary burdens.

This implies a strong role for the home supervisor, especially with respect to applications and validations, which in turn relates to the second essential point made elsewhere in our comments: regulatory efficiency requires full recognition of the fact that many of the complex requirements of Basel II and CRD can only be met at the group level. We do believe that additional procedural clarity is advisable for the home/host relationship. This might include formalizing conclusions, for example in the form of “qualification certificates”¹, as one member has proposed, for homes to deliver to hosts. It should be stressed that maximizing *procedural* clarity is different from resolving certain other *definitional* issues where shared supervisory approaches and understandings may not (yet) be translatable to fixed, common standards.

In addition, a separate “fail safe” provision should be added to make it clear that banks’ good-faith implementation efforts, necessarily undertaken before final supervisory guidance was available, should be respected and accepted, at least for a transition period lengthy enough to allow banks to bed down their systems, recoup their development costs, and plan future enhancements in an orderly way. This may require recognition on the part of host supervisors of the necessity to accept informal arrangements worked out with home supervisors during the “pre-application” phase.

Status and Nature of the Guidance: WG member banks would be interested in seeing CP 10 define more clearly the status of the guidance and clarify what is expected of national supervisors. Although such may not be the case from a technical, legal viewpoint, in many aspects CP10 is likely to be interpreted as essentially a further level of regulation, potentially limiting or replacing understandings developed during other consultation processes (both at the international and national levels). The extent to which supervisors are supposed to follow the guidance and the responsibilities of banks under the guidance requires full clarity in the text. Certainly, a differentiation between “must have” and “nice-to-have” recommendations is something of fundamental importance since it will define to a large extent interactions between banks and their supervisors during the implementation period. While it is recognized that the guidance of a Level 3 Committee does not constitute binding rules in the legal sense, the strength of each recommendation both to the banks and to the supervisors should be made clear.

Internationally active banks are already at a crucial stage in interpreting the framework in order to produce evidence of compliance against the requirements set forth by the new framework, something that requires clear and unambiguous guidance along with recognition of the work that

¹ Under this idea, there would be a “qualification certificate” that home supervisors could deliver to hosts, which would certify compliance with principal requirements in regard to advanced approaches. This could be part of the global (not just European) home/host process and could be performed for each portfolio.

has already been done by banks. Guidance should be suitably principles-based to accommodate the range of implementation strategies that are already being rolled out on a group-wide basis by many banks. In addition, a clear indication of the timeframe for implementation of the guidance is also necessary.

Scope: Given that by now institutions will have already had to make decisions on how to build their rating and AMA models and implement them using existing historic data and experience requirements, and on the basis of the best Basel II information available, the many specific requirements and detailed discussions in CP10 seem ill-timed.

As an overall proposition, the WG's suggestion is that the guidance should provide specifics as to *supervisory* policy and procedure for applications and validations in order to provide a framework capable of assuring the level playing field across the EU. Unless there is a strict necessity with respect to particular issues (which necessity should be fully explained), CP10 should avoid establishing prescriptive additional requirements on *banks'* internal practices and models.

While examples may be intended to be merely that, it appears highly likely that they will quickly become de-facto checklists or rules. If, contrary to industry recommendations, it is decided to retain examples, they should clearly be labeled as merely suggestions, and it should be made exceedingly clear that they should not be interpreted as in any sense mandatory in Member States' implementation efforts.

Prescriptiveness: Given the voluminous requirements set forth in the original Basel II framework as well as in CRD, banks are primarily seeking at this stage pragmatic and effective guidance as to how IRB and AMA approaches should be implemented and validated and, equally importantly, as to how supervisory requirements should be satisfied. A principles-based approach that provides high-level guidance on key validation and implementation issues would be welcomed. For example, Par. 444, regarding the institution's responsibility to work on an ongoing basis to ensure data quality, provides a clear objective while allowing flexibility in meeting this requirement.

Against this background, WG members believe that CP10 may inadvertently be interpreted as introducing numerous prescriptive requirements beyond those established in the CRD (e.g. Par. 64, 168 and 225 regarding the IRB and Par. 437, 438 and 445 regarding the AMA). The value added of several areas of CP10 - where strict compliance would be onerous but the language does not obviously increase accuracy or validity of banks' approaches (e.g. data for parameter estimation, in particular cost allocation within LGD estimation as prescribed by Par. 222-239) - is not evident. In many instances, the unnecessary detail that is supplied runs counter to the very objectives of flexible IRB and AMA approaches that rely on banks' internal practices. Furthermore, unnecessary detail that will inevitably be treated prescriptively or as nearly mandatory benchmarks could stifle the further development of best practices in the industry.

While members are confident that CEBS fully realizes this, it is worth emphasizing how even minor requirements added to the implementation process can have major impacts on banks' preparations and result in an increased implementation cost burden for banks.

Finally, the WG consider that an extra effort could be employed to synthesize the guidance so that it becomes the practical implementation instrument that it is intended to be. It is not helpful for the guidance text to repeat the CRD text, something that is even potentially dangerous where the CRD text is subtly re-phrased or summarized (e.g. Par. 54 summarizes the minimum requirements defined in the CRD, replacing them with the not-exhaustive list within CP 10).

Instead of clarification, this leads to further uncertainty regarding the minimum requirements for supervisory assessment. The preference would be for a more concise document, with cross-references to the CRD. Any quotations from the CRD or other existing texts that are nevertheless deemed necessary should be verbatim and should be clearly identified as such. Interpretive glosses on such texts should be clearly differentiated.

Governance and Control: The WG have a number of concerns about the specific provisions contained in CP 10 regarding governance and control structures, as well as the role of senior management regarding IRB and AMA models. Although detailed comments on some of these provisions are presented in the next sections (or in correspondence on other CPs), IIF member banks are generally concerned about the excessive level of prescriptiveness present in CP 10 as to the role of senior management in regard to advanced models. Involvement by either the supervisory level or senior management in details as opposed to strategy and oversight of processes may create inefficiency and could even detract from good risk management practices.

In many instances, CP 10 could be read as establishing new requirements beyond those established in the CRD, something that not only adds to the complexity of the framework but also could interfere with the latitude that banks require when designing their internal risk management structures. Furthermore, many of the requirements in this area lack clear justification, seeming to dictate choices in management structure that are better left at the bank level. It is appropriate for CP10 to define the results a sound governance and control structure should provide, and perhaps procedures for supervisors in examining governance and control (in particular where subsidiaries of cross-border groups are concerned), but the WG's view is that it is not appropriate or helpful for CP10 to define yet another set of corporate governance structures. Given all the other rules and regulations on governance and control, CP10 should very carefully stick to principles that are necessary to achieve the goals of CP10, and not attempt to set any formalistic norms as to how those principles are to be achieved.

II. Specific Comments

A. IRB Issues

There are a few specific issues on which the WGCA would like to provide views, given their important implications for the implementation and validation of IRB approaches from the perspective of internationally active banks. These issues are:

1. **Documentation Requirements and Self-Assessment:** The combination of documentation requirements arising from the “use test” and those related to the obligation of banks to demonstrate to their supervisors that they meet minimum requirements at the outset and on an ongoing basis poses many challenges for banks. Because of the novelty IRB represents, there is a clear danger of imposing excessive regulatory burdens if too much granularity is applied to that demonstration and if the “use test” is interpreted too literally. There is therefore a risk in that a “general” request for the documentation contained in Par. 277 and the description of self-assessment contained in Par. 64 could easily devolve to a voluminous, paragraph by paragraph, self-assessment process, unable to differentiate amongst mission-critical elements and less-central aspects.

In setting the tone and level of expectations, CEBS's guidance will be a critical determinant of regulation for years to come. Guidance to supervisors should stress that sampling is often more than sufficient to establish, for example, that the use test is being complied with;

similarly, it will often make more sense to examine procedures than to check off requirements against each portfolio, each business, each branch, each subsidiary.

2. **IRB Governance and Control:** As already mentioned above, several provisions in CP 10 would establish excessively detailed requirements in the area of governance without clear justification, limiting the ability of banks to implement equally valid and robust risk management and control structures. For example, Par. 385 requires that the head of the control function should be subordinated to a person who has no responsibility for the activities that are being monitored and controlled. In practice, this could be interpreted as implying that risk methodology and validation units may not be part of the risk management function, something that is common practice in many institutions.

Paragraphs 365 to 370 on Internal Governance impose specific, prescriptive obligations on banks' supervisory bodies and senior management in relation to Credit Risk. These prescriptive requirements could mean that, for example, institutions will need to modify board level or senior management committees' functions, limiting each institution's capacity to decide what management structure best suits its strategy, organizational form, internal culture, etc. This level of prescriptiveness could clearly be avoided by devising a principles-based approach, which establishes the objectives sought and allows banks to determine the specific ways in which those objectives ought to be achieved. [Note: please see the following section for specific comments on governance issues related to the AMA.]

3. **LGDs:** IIF member banks have been particularly involved in the dialogue with the Basel Committee in the area of LGD calculation. A core principle for internal parameter estimation has been to allow banks to develop best practices through time, based on key minimum requirements set in the Accord and in recent Basel Committee guidance. With this in mind, Par. 233 contains excessively prescriptive requirements that would go against the necessary flexibility for industry practices to evolve.

B. AMA Issues

Overall, the WGOR is supportive of CEBS's intention to clarify practical validation and implementation issues related to the Advanced Measurement Approach (AMA) for calculation of operational risk capital requirements. The guidelines set forth in CP 10 represent a significant step toward the practical implementation of an AMA within the EU, and further clarify supervisory thinking in a number of areas. This will be useful in the broader dialogue among the industry and supervisors concerning the evolution of operational risk measurement and management as well as in bilateral discussions among banks and supervisors regarding implementation of Basel II.

Concern does exist, however, that, in many areas, the guidelines are too prescriptive. Where possible, this should be avoided and CP10 should embrace a principles-based approach, rather than one based on numerous examples. As CEBS recognizes, the AMA is meant to be a flexible approach, not only with respect to methodology but also in regard to how it is used and implemented within a bank. The lack of flexibility in implementation and use (as well as methodology) will undermine the approach and stifle development. Any examples that could possibly undermine this flexibility should be excluded from CP10.

Even if it is clearly stated that examples included in many areas of the consultation paper are not exhaustive and are provided solely for illustrative purposes, there is a further concern that a "tick-the-box" approach to these complex issues could arise during the AMA application review and

validation process. This result would be inconsistent with the fundamental objective of the AMA as an internal models approach.

Furthermore it has been noted that CEBS will issue a second consultation paper in the first quarter of 2006 that will likely address key issues such as the treatment of expected loss (EL), correlation, data standards, and validation techniques. The WGOR believes that continued discussion among the industry and regulators on these issues is essential and looks forward to future collaboration with CEBS as these topics are considered. As mentioned above, the WGOR encourages CEBS to avoid prescriptiveness in any guidance issued and to emphasize high-level principles that are consistent with the flexibility of the AMA. The WGOR also encourages CEBS to coordinate with other supervisory groups, including the Accord Implementation Group's Operational Risk Working Group (AIGOR), to ensure that guidelines on these and other areas are as consistent as possible across jurisdictions. The WGOR has met extensively with the AIGOR and has prepared written submissions to this group, most recently on the topic of EL, which may be of use to CEBS.

1. General AMA Issues

The WGOR considers well-reasoned guidance on several key topics to be of utmost importance in ensuring the successful implementation of the AMA on a cross-border basis. The following comments highlight these priority issues for consideration:

- **AMA Allocation (Par. 464)** In particular, the WGOR is pleased to see that CP10 supports the guidelines set forth in the Capital Requirements Directive (CRD) that would allow allocation of a diversified group AMA calculation to subsidiaries of a banking group within the EU (e.g., Par. 51 and 464). However, the WGOR recommends that Par. 464 be broadened to make clear that allocation within the EU will also be allowed for those EU subsidiaries that are part of banking groups headquartered outside of the EU. It is crucial to the success of the hybrid AMA that supervisors consider an allocation from a group AMA calculation for non-significant subsidiaries, as will be specified in a bank's AMA application. Any restrictions on considering allocations to EU subsidiaries from non-EU headquartered banks would appear to be inconsistent with the guidelines for implementation of the hybrid approach issued by the Basel Committee's Accord Implementation Group and with the basic tenets of a risk-based approach to operational risk. The WGOR urges CEBS to clarify this point in CP10.
- **Home/Host Issues (Annexes I and II)** –Furthermore, the WGOR supports the broader guidance given on the approval process for review by home and host supervisors of an AMA application within the six-month period specified in Article 129(2) of the Capital Requirements Directive (CRD). Although the specifics of CP 9 *Guidelines for Greater Supervisory Cooperation* are beyond the scope of this comment letter, the WGOR would like to stress the importance of continued dialogue and development on home/host issues. Only with effective home/host coordination will the benefits of the AMA be realized through effective implementation of the hybrid approach. If supervisors were not to allow an allocation of a group capital requirement to “non-significant” subsidiaries, firms may have no choice but to revert to use of the AMA at the group level only, with implementation of either the Basic Indicator or Standardized Approaches at the subsidiary level. This could seriously undermine the basic objective to develop a risk-sensitive approach to the operational risk requirement.

- **Use Test Principles (Par. 435-437)** Although the working group is very supportive of the broad concept of the “use test,” the WGOR would like to emphasize the need for flexibility in meeting the “use test” and the desire to avoid prescriptiveness in this area. While high level principles, such as those included in CP10, are considered appropriate, there is concern that the examples that have been included could become a “check list” for regulators when evaluating a bank’s compliance with the use test. Furthermore, the use test examples may curtail flexibility and result in a “one size fits all” approach. The WGOR would like to stress that the relationship between the operational risk framework and operational risk management, in a particular instance, should reflect the specifics of how a particular business line is managed. From the WGOR viewpoint, the bottom line should be whether the AMA framework (including model inputs) is being used in the day-to-day management of the bank rather than whether a bank meets a specific example that may not be applicable to its particular business model and management framework. Moreover, “use in day-to-day management” should be interpreted broadly and not too literally, to avoid making the use test a formulaic constraint on management, rather than a test that management overall is consistent with operational risk data and models.

Furthermore, although the four principles are broadly acceptable, principles 1, 2, and 4 should be modified so that “operational risk measurement system” is changed to “operational risk framework”, as described in principle 3. The rationale for such a change is that while the *outputs* of an AMA model may not be used in the *daily* management of operational risk, the *inputs* that go into this model are an essential component of operational risk management. For example, loss data and self-assessment information, which can feed the model for purposes of the regulatory capital calculation, are very pertinent to sound operational risk management. Therefore, a broader concept of the “operational risk framework” is more appropriate than a strict view of a “measurement system.” The use test should be an overall assessment of how the bank relates to the AMA model and its inputs, and not a mechanistic or literal application.

A final point regarding the use test is that the word “continually” should be deleted from principle 2. While banks support the concept of an evolutionary operational risk framework, this should occur when changes are warranted, which may not necessarily be on a continual basis.

- **Reconciliation of Loss Data and Data Consistency Standards (Par. 442, 443, and 445)** In two places, CP10 refers to “cross checking operational loss data with material accounting data.” In some cases, reconciliation with accounting data may be extremely difficult, or impossible, to do and, in any case, would not demonstrate completeness of data. For example, a single operational risk loss event may be related to numerous items in the general ledger. Disaggregating the various impacts and reconciling these to the G/L would not only be difficult or impossible to do, but also would have no benefit for purposes of operational risk management. Although some validation of loss data against financial reporting numbers is feasible, a full, detailed reconciliation is not possible because the nature of operational risk losses is so diverse. The WGOR stands ready to discuss this issue in more detail with CEBS and to provide specific examples of the operational challenges of an accounting reconciliation, if that would be helpful.

Apart from accounting reconciliation, banks are developing a number of alternatives to demonstrate completeness of the loss database, and these will vary from firm to firm. Alternatives could include sign-off by management teams, cross-checking of op risk data reports, and training. Furthermore, banks should be able to rely on existing processes (e.g.,

internal audit procedures or Sarbanes-Oxley Section 404 controls) that ensure data quality and integrity. The examples included in Par. 443 and 445 are too prescriptive and may not be useful to every firm dependent on its approach. The WGOR recommends that the CP should avoid narrow references to an accounting reconciliation, decision trees, and the like and promote a more flexible approach that is aligned with internal practices and, therefore, consistent with the use test.

2. Specific AMA Issues

In addition to the aforementioned priority issues, the following comments on specific points addressed in Section 4 of CP10 are provided for your consideration:

- **Partial Use (Par. 418 and following tables)** Broadly, the WGOR supports CEBS’s flexible approach to partial use of the AMA throughout a banking group. However, Table 2 should be modified to allow for partial use of the AMA at the business line level along with use of the Basic Indicator or Standardized Approach at the legal entity level. Many banking groups manage operational risk along business lines, and may choose to roll out an AMA for a certain business line while continuing to calculate the operational risk capital requirement by a less sophisticated approach at the level entity level.
- **AMA Roll Out**
 - **(Par. 428 –429)** The WGOR questions whether it is necessary to include the guidance set forth for a “materiality assessment” of a bank’s AMA roll-out plan. The bank should provide an overview of its use of the AMA for all or part of its operations as part of the application process, and it should be up to the bank to demonstrate compliance with the AMA roll-out and partial use provisions of the Framework (Par. 680 – 683).
 - **(Par. 431)** It should be made clear whether this paragraph is only applicable to partial use institutions or (the partial use section begins and ends before this one) or whether it is intended for all AMA banks. If this paragraph applies to any AMA firm that is still in the process of incorporating non-core business line(s) in its framework, the suggested alternatives are complex. Furthermore, the benefits of giving institutions and regulators three alternatives to communicate such intentions are neither clear nor concrete. Suggested language could simply state that institutions and regulators would collaborate and AMA implementation plan reviews would occur as agreed.
- **Data Quality (Par. 444)** The principle set forth in paragraph 444 regarding data quality is an excellent example of the principles-based approach that should form the basis of CP10. The WGOR wholeheartedly supports this principle and recommends that other sections of CP10 be modified to put forward a similar high-level view.

- **Validation (Par. 452)** Although the principles of the AIG High Level Principles on Validation are, when taken very generally, relevant to the AMA, the examples included in the AIG’s document focus solely on IRB validation. If CEBS were to provide additional guidance in this area, consideration should be given to whether the High Level Principles should be adapted for AMA purposes and how the accompanying examples could be modified to apply to AMA validation.
- **Insurance (Par. 463)** Paragraph 463 should be modified to specify that a haircut is not required as long as a bank has a defined process in place to renew existing insurance policies. In many if not most cases, it is not possible to have an “automatic renewal option” with the conditions as described in Par. 463 included in insurance contracts. Rather, they are renegotiated according to a defined company procedure, whereby the likelihood of non-renewal is low. This should not detract from the use of insurance as an operational risk mitigant.
- **Role of Management Body and Senior Management (Par. 470 – 476)** The WGOR acknowledges the central importance of strong management oversight of the operational risk management function (ORMF) and urges CEBS to modify CP10 guidance to focus properly on the oversight role of management rather than on the details of the day-to-day functions carried out by the ORMF. Furthermore, in Par. 473, the WGOR suggests CEBS’s broaden the statement beyond “new products” to reflect that the management body is responsible for identifying and appropriately managing risks tied to new product development and other significant changes to ensure that the risk profiles of product lines are updated regularly.
- **Operational Risk Management Function (Par. 482 -487)** The WGOR welcomes CP10’s flexibility regarding the organizational structure of the ORMF and its independence (Par. 486 - 487). While some banks rely primarily on a centralized ORMF, others prefer to embed staff within a specific legal entity or business unit. Par. 486 and 487 recognize that a variety of approaches are possible, while still maintaining the independence of the ORMF, and the WGOR welcomes these two paragraphs as good examples of a principles-based document.

The WGOR also recommends one minor change to Par. 482. It is advisable to change the word “should” to “could” in recognition of the various combinations of tasks and responsibilities that the ORMF might carry out.

III. Conclusion

The IIF appreciates the opportunity to provide these comments and stands ready to provide additional views or offer clarifications on its recommendations. We look forward to continuing dialogue with CEBS on these fundamental issues on behalf of IIF members. Please address any comments or questions on this paper to David Schraa (dschraa@iif.com, +1 202 857 3312). For IRB issues you may contact Andres Portilla at aportilla@iif.com, +1 202 857 3645 and for AMA issues you may contact Molly McGregor at mmcgregor@iif.com; +1 202 857 3311.