IIF Working Groups on Capital Adequacy and Operational Risk
February 16, 2006

Comments on the revised 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) appreciates the opportunity to comment, on behalf of its members, on the revised Consultation Paper (CP10). As on previous occasions, given its international vocation, the Institute does not propose to comment in detail on all the specific provisions contained in the revised CP 10 but rather on broad issues and a few specific issues of particular interest for members. The working groups would also like to emphasize that they are generally supportive of the comments presented jointly by ISDA, LIBA and the BBA. As in our previous response, the IIF will provide comments through its Working Group on Capital Adequacy (WGCA) and Working Group on Operational Risk (WGOR), collectively referred to as the Working Groups (WG).

The WG would like to express their sincere appreciation for CEBS's willingness to engage the industry in dialogue and for the detailed feedback CEBS has provided on the first round of comments received. Also, the industry is appreciative of the positive reaction of CEBS to the comments that have been incorporated in the revised version of CP10. Certain added features are also useful, such as the recognition of the "comply or explain" concept in the area of governance.

However, although we understand and share CEBS's interest in finalizing the guidelines promptly, the industry is concerned about the short consultation period allowed for the revised CP10. Given the significant changes introduced in this new version, in particular in the areas of equities, purchased receivables, securitization and operational risk, the limitation of the new consultative period to one month has affected our ability to provide more detailed comments. In members' views, the significance of the changes introduced would have justified a longer consultative period.

In reviewing the revised text of CP10, the WG have identified some key general issues, applicable to both the IRB and the AMA sections of the guidance. These issues are:

Prescriptiveness: The WGs recognize the challenging nature of the task of producing guidance that promotes harmonization of supervisory practices without creating further prescriptiveness. However, in our view, excessively detailed rules do not contribute to the goal at hand but rather restrict the necessary flexibility for the initial design and implementation of internal models. To reiterate our main message from our previous response, CEBS should work to achieve principles-based guidelines for supervision that avoid any undue prescriptiveness with respect to firms' risk management practices and yet ensure consistent cross-border regulation and minimize the complexity of home-host issues for internationally active banks.

Furthermore, the WGs are concerned about the introduction of detailed requirements at this relatively late stage in the implementation process. Although CEBS has included a "good faith" clause in para 14a, the WGs would like to point out that this is only a temporary measure and that systems that have already been developed would have to be modified in due course. Most banks have already invested significantly in processes and instruments to be compliant to the AMA and IRB requirements as required in the CRD.

Based on the revised CP 10, a considerable number of additional requirements would be imposed on banks that may not be aligned with their current implementation plans already underway. While CEBS may not have intended all these provisions to be per-se requirements, not only is there a danger of their being so interpreted, but members report supervisors are already treating them as such. This presents banks with difficult and costly new implementation problems, especially when they are well advanced with implementation efforts that are in line with Basel principles. Much of the prescriptive details appear to be not only unnecessary for convergence purposes (which can be fostered by well designed principles) but to constitute a degree of goldplating that is unhelpful at this point in the process.

The WGs also consider para 14a to be at odds with the CRD. Since the CRD is in the form of a directive rather than a regulation, it allows the national legislator explicit degrees of freedom regarding the implementation in national legislation. Para 14a, however, does not accept any deviation from the guideline over time. While the goal of convergence of supervisory practice is a worthy and even essential one, this paragraph swings too far in that direction.

Home/Host Issues: IIF members would like to reiterate their interest in making a reality the Basel Committee's goal of a global level playing field. Given CEBS's mission, we believe that CP10 can be an important and effective instrument in promoting greater convergence and harmonization of approaches among international supervisors. IIF members have a deep interest in effective guidelines for the exchange of information and allocation of responsibilities between home and host supervisors. Against this background, we should note that some provisions in the revised CP10 have taken a step back in terms of promoting such effective allocation of responsibilities.

Chief among them, the revised text of para 80 no longer requires that "within six months, the competent authorities shall agree their determination (…)" but rather requires that supervisors "do everything within their power to reach a joint decision". In our members' view, the weakened language (even though it cannot abridge the relevant provisions of the CRD) sends the wrong message and may discourage supervisors from reaching a decision on this crucial issue.

Furthermore, the key issue of arrangements between EU and non-EU supervisors still remains open. While we understand that in a strictly legal sense the scope of CP10 is restricted to EU supervisors (as mentioned in para 15a), the reality is that CP10 and similar guidance will have a direct impact on the regulatory interactions outside the EU, either via precedent set by the guidance or via the exchanges between EU and non-EU supervisors. Therefore, the WG would commend CEBS to continue consideration of this issue and future guidance with the objective of promoting a clearer framework for interactions with non-EU supervisors.

In the remaining part of this document the WG will address specific IRB and AMA issues regarding both the new sections introduced to CP10 and areas where concerns remain from our previous response.

II. IRB

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, are the following:

A. Equity Exposures (3.3.1.4)

The WGCA believes that the proposed language on para 187r of CP10 goes beyond the text on the CRD (in particular the definition contained in Article 86 of the CRD). While implementation guidance can be helpful in cases where the rules are not clear or easy to implement, the introduction of additional explicit criteria beyond those prescribed in the CRD is a source of concern for the industry. In effect, banks consider that the widening of the definition of the equity class via implementation guidance will create additional hurdles to the implementation of the CRD and introduce rigidities in an area that requires an appropriate degree of flexibility.

The WGCA would advocate avoiding new criteria in the equity definition and introduce requirements for transparent and auditable internal processes and criteria for the classification of debt and equity products. It is particularly important to retain flexibility regarding the treatment of these products to reflect market developments. Products with debt and equity characteristics, typically in mezzanine tranches, 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 judgment regarding these products takes several non-static dimensions into account to determine the degree of equity. In this sense, the proposed mostly one-dimensional guidelines are ill adapted for this purpose and might interfere with market developments.

In sum, the WGCA would advocate that CP10 adhere to the CRD definition of equity exposures as given Article 86 and that additional explicit criteria not be introduced. This is important in order to retain the necessary flexibility regarding the treatment of products in accordance with market developments and would be in line with the CRD. At minimum, the implementation guidance should retain the degree of flexibility contained in the CRD definition. There are several examples of additional requirements introduced in the guidance. These are provisions that the WGCA would advocate eliminating:

- **Equity definition (para 187r):** the CRD does not require a capital charge for indirect equity holdings. CP10 should avoid widening the equity definition.

- **Missing maturity (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 one single feature. In this case, for example, step-up clauses can make repayment nearly certain, even if the issuer legally has the right to defer repayment.

- **Assignment of convertible bonds to the equity segment (para 187x):** Since the conversion of bonds into shares / equity is only an option, the exposure should be treated as any bond, as long as the option is not executed. Only after conversion of the bond into shares the exposure would be assigned to the equity segment.

- **<u>Choice of approaches (para 188 and 188c):</u>** The guidance 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.

- **<u>Active Management of private equity exposures in sufficiently diversified portfolios (para 188d):</u>** The guidance should not refer to active portfolio-management as a criterion for sufficiently diversified portfolios. Sufficient diversification and active portfolio-management are different criteria. Given that the CRD only refers to sufficient diversification, CP10 should refrain from introducing a new, additional criterion.

B. <u>Securitization</u>

As is the case with the proposals on equity exposures, the WGCA is concerned about the level of detail of the guidance on securitization. In their view, most of the guidance as written is superfluous from a principles perspective and could make more burdensome the implementation of the CRD. In particular, there is serious concern that in debating the issue of Significant Risk Transfer, and introducing a number of considerations in the process (e.g. reference to accounting practice), CEBS has not provided the clarity and guidance sought by supervisors. On the contrary, less-sophisticated supervisors may consider the determination of Significant Risk Transfer open to interpretation, thereby tilting rather than leveling the playing field.

In this regard, the WGCA believes that para 187 assigns excessive discretion to the national regulatory authorities in assessing the effectiveness of risk transfer. This discretion could lead to a wide range of differing regulatory practices (and therefore to distortions of the level playing field) ranging from a case-by-case approach by assessing the transaction specific risk transfer to prescription of a "quantitative threshold" based on EL/UL calculations or considerations. CEBS should consider ways to address the potential variation of supervisory practices and bring this part of the guidance more in line with the principles-based approach.

Furthermore, although we recognize the difficulty and the trade-off, we observe that CEBS has elected to provide granularity and prescriptiveness in its attempt to achieve convergence; hence the use of examples. While our preference is to avoid examples, we would urge that any examples CEBS does retain be factual and unambiguous, without raising further issues that industry would debate. In view of this, we believe that Section 3.3.1.3 should be rewritten to achieve a clear and principles-based interpretation with respect to Significant Risk Transfer.

Finally, we would like to point out that practical problems arising in the calculation of RWA are not addressed, e.g. securitizing assets from the trading book (where reference to RWA is unclear), the sum of exposures - including derivatives - larger than the pool of assets, and third-party transactions employing sponsored SPVs.

In addition, other aspects of the guidance need clarification, including para187a, where the listing of IRB approaches is incomplete, leaving aside the IAA and FBA approaches.

C. LGDs (3.3.3.2)

As CEBS is aware, the issue of downturn LGDs has been subject of extensive dialogue between the industry and the regulatory community and a process for formal exchange on the issue has been established through the Basel Committee. One product of that dialogue was the Guidance document issued by the Basel Committee in July 2005. Although apparently CEBS's intention was to incorporate such guidance in CP10, WGCA members believe that the selective approach employed (introducing some aspects of the guidance but leaving out some other key ones) has brought CP10 closer to the view, already discarded in the original Basel Committee guidance, that a positive correlation between default rates and recovery rates exists for every portfolio in every economic situation.

CP 10 does not include an essential component of the Basel Committee's guidance, which explicitly recognizes that "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." In IIF members' view, a more balanced treatment of downturn LGDs in CP10 ought to include this key element. Moreover, certain statements in the new guidance might open the door to arbitrary requests from regulators in an area that the Basel Committee itself has recognized as in need of flexibility and pragmatism. One of such statements is found in para 239(a) which indicates that "While institutions are building better data sets and developing more experience in estimating downturn LGDs, supervisors may choose to direct them to focus their efforts on types of exposures for which they believe the downturn effect is of special concern." This, in our view, would go against the necessary flexibility that should characterized regulatory interaction in an area where industry practices still need to evolve. In general, firms will be best suited to determine where development efforts should be focused given their particular business mix.

Furthermore, it should be observed that the requirements of 239a (1) "Identifying appropriate downturn conditions for each supervisory exposure class within each jurisdiction" could be interpreted as going beyond the referred CRD paragraphs (Annex VII; Part 4; 73,74). These requirements on data availability (i.e. for each supervisory exposure class within each jurisdiction) not only will cause severe practicality issues but also exceed those included in national guidance already proposed by several jurisdictions.

The WGCA also would like to note how the guidance lacks clarity on certain key aspects. For example, the definition of LGD versus EL_{BE} on defaulted assets remains confusing even to expert personnel. WGCA members are unclear about how the add-on (reflecting possible additional unexpected loss during the recovery period) is to be calculated and what the connection is with LGD calculated based on historical data. Furthermore, WB members are unclear why they would have to apply this treatment on an individual basis, even on retail exposures. In their view, this cannot be understood where provisions are established on a statistical basis for a whole portfolio. In sum, WGCA members struggle to understand the global consistency of the proposed framework and would favour an approach closely based on banks' internal practices.

Therefore, WGCA would like to reiterate once again the urgent need for a flexible framework around the downturn LGD issue, one that will not lead to prescriptive local rules. A multiplicity of valid and robust bank practices exist and will continue evolving in the future. A pragmatic and flexible approach is necessary for those practices to continue their evolution, and therefore, CP10 should avoid prescriptiveness in this area.

D. IRB Governance

As previously indicated, the WGCA recognize the significant revision that the section on IRB governance was subject to after the initial round of comments. We believe there is some improvement and that the guidance as revised provides greater flexibility than the one originally proposed. However, the WGCA believe that some issues remain. Specifically, according to para 385: "the head of the control function should be subordinated to a person who has no responsibility for managing the activities that are being monitored and controlled". This technically would imply that that risk methodology and validation units may not be part of the risk management function, which is common practice in many of member institutions. Furthermore, further clarification is needed in para 360, determining that an adequate control process is sufficient and no separate organizational unit is required for small institutions.

The WGCA believes, therefore, that additional clarity is needed so that valid and robust governance practices are not unduly restricted by the guidance. Once again, a principles-based approach would be in order to achieve such goal.

E. Other Issues

A few other specific issues related to the IRB are of interest to members. These issues are:

- **Data quality control by replicating the preparation of data (para 306):** the guidance states that data quality could be reviewed by replicating the preparation of data and model output based on a sample of data. The data sample as well as the review process could then be audited by the supervisor. In our view, this process could bring unnecessary duplication of data preparation (original and sample data has to be prepared). Therefore, our recommendation would be that no duplicate data preparation should be required for supervisory review purposes.

- **Comparability of data sets (para 312):** The guidance prescribes that institutions should demonstrate the comparability of data sets by analyses of the population of exposures. This requirement causes practicability issues since exposure information is generally not provided with ratings of ECAIs or pools.

- **Back testing (para 340 – 344):** There appear to be inconsistencies between specific guidelines set out in para 340 and more general principle guidance (principle 5). In effect, while para 340 states that institutions should take action if internal validation thresholds (i.e. derived from confidence intervals) are exceeded. Principle 5 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 in para 340) contradict principle 5. Alignment with what is prescribed by the general principle should be established.

- **EAD modelling (para 245):** The guidance is excessively restrictive by using Conversion Factor (CF) on the undrawn amount - a common but by no means universal modelling approach. While the restriction to the CF modeling is originally a CRD issue, CP10 effectively removes all potential for applying alternative EAD models. An attempt to accommodate guarantee products in para 261 (for which the proposed CF approach is clearly unsuited) would fail, as there is no clear statement as to what "undrawn" would mean for guarantees.

- **<u>Implementation burden (Art 167)</u>:** The guidance, by requiring 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." creates a circular reference and thus is impractical in practice. The unaltered, connected requirement in Para. 168 to measure loss volatility for all three retail classes implies a high iterative workload. Similarly, unchanged para 352 requires that "Limitations owing to the dataset should not exempt institutions to perform a quantitative validation in Low Default Portfolios". This is a contradiction in terms, as lack of data will not allow for useful quantitative validation; the paragraph will thus create unnecessary work that should be eliminated, in line with the guidance provided by the Basel Committee AIG on the validation of Low Default Portfolios.

- **<u>Unclear scope and definitions in para 277 and 337:</u>** The guidance lists an abundance of documentation required without differentiating between rating development and parameter calibrations. This paragraph could be easily misinterpreted, potentially causing supervisors to ask for the impossible, i.e. a "CF rating system" or "LGD model output (…) calibrated to default probabilities". Therefore, the request to clarify to which risk parameter the individual positions listed in this paragraph apply should be addressed. Equally, para337 continues to demand that "In cases where lack of data (internal or external data) prevents the proper use of benchmarking and/or back testing, institutions should apply an appropriate (was "higher") margin of conservatism in their estimations." This leaves the definition and measurement of "appropriate margin" entirely open and gives no further guidance compared to CRD. At minimum, where no further guidance is offered, the provision should be eliminated.

III. <u>Operational Risk</u>

<u>A. General Comments</u>

Level of Prescriptiveness

As stated in the general overview, the WGOR is concerned about the increase in prescriptiveness in CP10 Revised from CP10. In their present form, the proposed guidelines contain a high level of detail and frequently introduce additional complexity at what is considered by the industry to be a very late date since bank implementation plans are already well underway. We know that CEBS is aware of this issue and of the need for balance; however, the WGOR is concerned that the degree of prescriptiveness is disproportionate to any arguments made in favor of more guidance by some groups.

Furthermore, the WGOR would like to emphasize that AMA models are at a relatively early stage of development. There is a danger that this level of prescriptiveness could impede future methodological developments and create a premature convergence of approaches that could have negative implications for the development of the operational risk discipline in the long term. A prescriptive, "tick the box" approach detracts from the underlying premise of the AMA as an internally-developed, risk-based approach that is applicable to a particular institution's risk profile and business mix.

Although CEBS has indicated that many of the examples included in CP10 Revised are not meant to be mandatory or exhaustive, the WGOR fears that they may become de facto checklists as applied by internal audit or by some regulators. For example, the focus on a loss

distribution approach (LDA) in many of the examples could be interpreted as an implicit recommendation of that methodology. The WGOR is concerned that banks who choose not to adopt an LDA approach will be required to defend their choice of methodology in the validation process rather than to focus on the overall soundness and coherence of the framework chosen. The final CP10 guidelines should embody a principles- and risk-based approach that is consistent with the overall objective of the AMA as an internally defined measurement approach.

Scope of Guidelines

In particular, the new section 4.3.4 is too quantitatively oriented and theoretical without due consideration to the practicalities of AMA implementation. For example, there are many paragraphs that do not discuss actionable principles or rules but are of a descriptive nature and extend to a level of detail that the WGOR believes is beyond the useful scope of supervisory guidelines (for instance, in Annexes V, VII, and VIII).

Additionally, in many cases, the guidelines appear to be superequivalent to the CRD and, contrary to CEBS's stated goal of convergence, they also leave scope for national supervisors to impose even more onerous requirements on their regulated institutions. Both aspects undermine the concept of harmonization and prevent CEBS from achieving its goal of a level playing field within the EU.

Maintaining Incentives for the AMA

Certain specific sentences (discussed in more detail below) cause significant concern for the industry, as they diminish or eliminate altogether incentives for banks to pursue an AMA. Rather than focusing on this excessive detail, CEBS should seek to maintain incentives for banks to use an AMA by developing principles-based guidelines. Both the industry and regulators agree that the AMA measurement framework should be sufficiently related to the day-to-day management of operational risk to meet use test criteria, appropriately understood. It should be up to the banks to develop an operational risk measurement framework that meets the AMA requirements set forth in CRD and which can be justified to regulators through the validation process.

B. Priority Issue: Correlations

The WGOR's highest priority concerns are found in the section on correlations (paras 461x to 462f plus Annex VIII). Generally, the WGOR believes that this section, if not removed or rewritten substantially, could greatly reduce incentives for banks to use the AMA. This is the result of the substantial prescriptiveness that it imposes. Although certain parts of this section are consistent with a flexible approach to the correlations issue, such as the broad-based definitions found in paras 461y and 462 of which the WGOR is generally supportive, the majority of the text in this section is viewed as too detailed, especially in light of the evolving nature of the operational risk discipline in general and the use of correlations in AMA models in particular. As CEBS is aware, operational risk measurement requires a different approach than credit risk measurement for a number of reasons, and guidelines that preserve the flexibility necessary for banks to implement an effective operational risk framework are essential. It may be worth recalling that the Basel II concept of the AMA allows substantial scope for firms to define and defend their operational risk measurement approaches.

Para 462a: The WGOR strongly opposes the final sentence of para 462a: "In particular, institutions should calculate 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 requirement is viewed as overly conservative and will result in the overall capital charge for operational risk being the sum of individual risk measures. It may also even lead to superadditivity, which the industry does not believe is methodologically supportable and would further distance the regulatory capital calculation from internal practice. In contrast, the common agreement in the industry is that correlations between different risk classes are generally very low. Moreover, this standard would be more onerous than that specified in Basel II para 669(d), which specifies the maximum capital requirement is limited to the sum of different operational risk estimates. .

The consequence would be that the basic idea of reducing risk through diversification cannot be factored into the AMA model. Therefore, the AMA would become no more risk-sensitive than the Standardized Approach. *The proposed correlation assumptions in para 462a contradict the empirical evidence, industry practice, and the supervisory approaches to other risk classes, and therefore, should be removed.*

Para 462c: Paragraph 462c is too prescriptive as it presumes a particular type of approach to correlations. Industry analysis has shown that there is a wide scope for variance in banks' approaches to the assessment and incorporation of correlations. This is to be expected since any effect of correlation (or lack of correlation) may be embedded in the underlying AMA methodology. As it is not possible, or desirable, to have a "one size fits all" approach to correlations, the WGOR recommends that this paragraph be deleted.

Paras 462e – f: The WGOR would like to see a greater emphasis on the need for qualitative judgments and reliance on expert analysis in the validation of correlation approaches. In many cases, a pure statistical validation measure will not be possible due to the low number of data points. Therefore, a reasoned judgment may play a role as part of a bank's validation processes. The WGOR has developed several principles to guide the validation process (included as Appendix B) and would recommend that CEBS consider whether it is appropriate to include such principles as part of CP10 Revised.

Annex VIII: The WGOR considers that the methodology is not yet sufficiently developed to include many of the descriptions contained in Annex VIII. Although the WGOR encourages further exploratory, theoretical discussions between regulators and the industry on the themes developed in Annex VIII, the working group believes that the Annex is not helpful in the context of CP10 revised and that it should be removed from the document.

C. Comments on New AMA Quantitative Section 4.3.4

- **AMA Approaches (para 449a):** The WGOR considers it inappropriate for CEBS to describe AMA approaches that have "begun to gain broad acceptance" because this could detract from the flexible nature of the AMA and lead to premature and forced convergence of industry practice. Since the principles set forth are closely related to the LDA and scenario-based (SBA) approaches, they could discourage the development of other methodologies. Furthermore, they present a narrower view than is found in the CRD. The WGOR recommends that CEBS either broaden this section to make it very general or remove it altogether.

- **Combination of Four Elements (para 455):** As is understood from explanations given verbally by regulators, the WGOR would like CEBS to clarify in the text that, although all four elements are an integral part of the AMA, some elements may be given a zero weighting

for purposes of the capital calculation. For example, some banks may not explicitly use one of the four elements (e.g., external loss data) as an input to the AMA model although it is an important component of the overall operational risk framework.

Para 455 could be revised to read, "The responsibility for determining how the four elements are weighted and combined rests with the institution." This would also be consistent with the language in para 456.

- **Definitions of Terms (paras 450-452 and 456b-h):** The WGOR finds the introduction of new terminology at this late date to be problematic for several reasons. First, certain of the descriptions used are vague, which could create misinterpretations, and they are used inconsistently throughout the text. For example, the distinction between the terms "multiple-effect losses" and "multiple-business line losses" described in these two paragraphs is not entirely clear. For some banks, the only types of losses that have broader effects are those that either occur over a period of time (i.e. where there are cashflows spread over a period of time - the "multiple time" losses from par 456(f)) and those that affect more than one Business Group. The latter type of loss appears to meet the definition of both "multiple-effect loss" and "multiple-business line loss". The rationale for such different specifications should be explained in more detail, possibly through examples that clarify such distinction (without, we hope, increasing prescriptiveness), or the distinction between the two categories of losses should be removed.

  Moreover, the introduction of new classes that are not part of Basel II could create a significant amount of work for banks that have already classified their loss data. In order to fulfill the new requirements, bank policies for loss reporting and database categorization may need to be changed to satisfy new definitions and data fields. Historical losses would need to be analyzed again, which could create significant additional effort. Introduction of new terms should be avoided at this stage and any definitions should be very clearly labeled as merely indicative for regulators, intended to explain common industry practice. Banks should retain the ultimate decision whether to adopt these definitions or to specify other definitions that they will document to regulators as part of the approval process.

- **Rapidly Recovered Losses (para 456(c) and para 456(j)):** The WGOR believes that these two paragraphs are unclear as they mix the issues of insurance use and rapidly recovered losses, which can be recovered by means other than insurance. Para 456j should be reworded and the guidelines regarding rapidly recovered losses clarified. Regarding insurance use, the first sentence in Section 456j states "losses and recoveries stemming from insurance policies should be recorded separately in the calculation data set". The WGOR suggests rephrasing as follows: "Institutions should be able to separate OR events (e.g. loss, recovery) related to existing insurance policies in the calculation data set." The proposed possibility to record net amounts in the case of rapidly recovered loss events is not customary in practice and the advantage of such an approach is unclear. Therefore, this requirement in para 456j should be deleted.

  More broadly, although CP10 does not prescribe specific requirements for rapidly recovered losses, it does imply that supervisors may define short time limits for a loss to be considered a "rapidly recovered loss." It is not clear to the WGOR why this requirement should be necessary since the capital holding period has a time horizon of one year. Furthermore, a very short time limit may result in an inordinate amount of work, many reversals, and recording of losses only a tiny percentage of which are real losses. Banks should be able to

define their own procedures in this area, subject to a requirement to defend their reasonableness to their primary regulators.

- **Loss Event Identification and Classification (para 456i-n):** CEBS should consider that all of the guidelines for loss-event identification and classification described in this section could be difficult and costly for banks to implement. In many cases, the results would be disproportionate to the actual risks faced by the bank, given its business mix, risk-management approach, and available data. It should be made clear that banks have the opportunity to specify their own appropriate guidelines for loss-event identification and classification and that the details described in this section (if retained) are merely indicative of what such guidelines might entail. Banks guidelines would, of course, be subject to supervisory challenge.

    - **Para 456k:** The sentence: "Multiple-effect losses should also be aggregated into a single loss before inclusion in the calculation data set" is overly prescriptive and does not account for possible situations where other calculation methods could be justified (i.e., multiple-effect losses impacting entities related to different business lines in different countries, with different risk profiles; in such cases, frequencies of the losses are perfectly correlated but severities are not necessarily), or where circumstances may not warrant such aggregation.

      The WGOR recommends this sentence be completed as follows: "Multiple-effect losses should usually be aggregated into a single loss before inclusion in the calculation data set; possible exceptions should be documented by institutions."

    - **Near misses (para 456l)**: The development of procedures to detect incidents or near misses is not addressed in the CRD and is thus an additional requirement. Although many banks may choose to record data on material near misses, this decision should be left to the institution rather than become a de facto requirement as part of the CP10 guidelines. In determining whether to collect near misses, banks will consider the costs and benefits of doing so and weigh the challenge of collecting “all” near misses against their materiality to the operational risk framework.

    - **Para 456n, first bullet:** This paragraph should be clarified to indicate that central losses included in a “Corporate Center” category do not necessarily need to be allocated or “assigned” to a particular Business Group for AMA purposes (as compared to “management purposes” as specified in para 456n). Furthermore, all examples describe such assignment on a loss-event level.

      To be inclusive of other methods of assignment, the example could be amended as follows: “Capital figures calculated for a centralized function can be assigned to the affected business lines in a well-documented way.”

    - **Para 456n, second bullet:** Similarly to the preceding, the sentence: "In any case, the aggregated amounts, and not the pro-rated amounts, should be included in the calculation data set" is overly prescriptive and does not account for possible situations where other calculation methods could be justified (i.e., multiple-effect losses impacting entities related to different business lines in different countries, with different risk profiles).

The WGOR recommends this sentence be modified as follows: "The aggregated amounts, and not the pro-rated amounts, should usually be included in the calculation data set; possible exceptions should be documented by institutions."

- **Minimum Loss Thresholds**

    - **Para 456p:** The content of this paragraph is purely descriptive and goes well beyond what is outlined in the CRD. The WGOR recommends this paragraph be removed.

    - **Para 456q**: The WGOR suggests the example "for example by linking thresholds to risk tolerance" be deleted as it implies that thresholds are currently set according to levels of acceptable/unacceptable loss, which is not the case. Banks can use many criteria for determining loss thresholds, such as the characteristics of losses in a certain business line.

    - **Para 456r:** The WGOR recommends the example "for example by making use of appropriate distributions and suitable parameter estimation procedures " be deleted as it implies that historical loss data is used in the data calculation set which is possibly not the case (see comments on Combination of Four Elements, para 455).

- **Scenario Analysis (paras 456z - 457a):** The WGOR would like to recommend some specific changes to the section on scenario analysis. Firstly, some banks use scenario analysis only for obtaining figures for tail events as per CRD requirements. However, para 456z could be inferred to require that firms need to establish scenarios for "normal" events as good practice. Many firms have chosen to use scenarios to supplement loss data to ensure complete coverage of risks. However, other firms use scenarios to populate the whole of the loss distribution.

  Therefore, the second sentence of para 456z should be amended to "In certain approaches, scenarios may be used to provide information on the institution's overall operational risk exposure."

  Moreover, it is unclear what is meant by "repeatability" of the scenario analysis process. By their nature, scenarios are analytical tools that contain elements that are subjective. Thus, it is doubtful that two people (or two groups of people) would reach the same exact conclusion given the same set of data. It should be clarified that "repeatability" refers to the process to estimate scenario parameters, rather than the outcomes of scenarios.

  Additional clarification is also required for the concept of "granularity of a scenario". The WGOR assumes that "granularity" in this context means the business lines, territories, entities, units, etc. in which the scenario is applicable and should be studied. Firms are not sure as to what statistical tests could be performed to address this requirement.

  Therefore, to avoid placing emphasis on a statistical or empirical approach to choosing a level of granularity to scenarios, the WGOR recommends this sentence be re-worded: "Institutions should be able to explain the rationale behind the level at which scenarios are studied and/or the units in which they are studied." This should also include whether a bank has chosen a centralized or decentralized approach (e.g., conducting scenarios by function in each business group) to scenario analysis.

Finally, the WGOR would like to reiterate that procedures for scenario analysis are still in an evolutionary phase. This should be considered when determining what guidelines to include in CP10 Revised.

- **External Data (para 456t – 456v):** The WGOR is concerned that too much focus is put on consortia, which could be interpreted as an incentive, or de facto requirement, for institutions to participate in consortia initiatives. This type of recommendation would not be in line with the overall purpose of the document. The WGOR suggests that these paragraphs be rewritten to summarize and state clearly that participating in consortia initiatives is up to the institutions and not an issue for regulators.

- **Business Environment and Internal Control Factors (para 457b –c)**: In para 454, CP10 Revised has modified with full justification the initial document by stating that "all four elements (are to be used) as inputs to (institutions') operational risk measurement systems" rather than "operational risk capital requirements model" as stated in the previous version. However, the new paras 457b and 457c do not seem in line with this modification, as different sentences could be understood as advocating for a direct input of BE&ICFs in the model itself: "BE&ICFs can be incorporated into the AMA model in different ways..." (para 457b); "Institutions should document where in their model they use BE&ICFs" (para 457c).

  The WGOR recommends that "model" be replaced by "system" in these two sentences, which is consistent with the terminology in para 457d.

- **Use of Qualitative Data (para 459):** The term "specialist" is vague and could lead to different interpretations of who may or may not meet this qualification. The WGOR recommends removing this paragraph because, even without this qualification, it will be the responsibility of the bank to demonstrate the appropriateness and soundness of their AMA model under the use test.

- **Model Execution (para 461c):** According to para 461c, loss events and loss amounts within operational risk classes should be independent and identically distributed. However, dependent loss events within a risk class can be modeled by using a negative binomial instead of a Poisson distribution for frequencies as well. The section should therefore be reworded as follows: "Institutions should seek to identify operational risk classes within which loss amounts are independent and identically distributed. Alternatively, institutions may wish to adjust their data for known drivers in order to simplify the modeling process as long as they can adequately justify any such adjustments."

- **Modeling Techniques (para 461c-f) and Annex V:** Broadly, the WGOR views the guidelines for Modeling Techniques as much too prescriptive, particularly when considered in conjunction with Annex V. The WGOR is concerned that the examples included in this section could become a checklist and would be difficult or impossible to apply in many cases. The WGOR recommends this section be rewritten so that the guidelines require the bank to demonstrate an accurate, sophisticated testing of model inputs and outputs for robustness and soundness, rather than including a list of statistical techniques.

  In addition, the WGOR is concerned that the guidelines presented for modeling techniques are too heavily oriented toward banks that have chosen to adopt an LDA approach. Steps 1-4 as outlined in para 461e are typically steps applicable to an LDA approach based on historical data, and may not be relevant to other approaches, particularly an SBA or a hybrid approach.

For instance, "goodness of fit" diagnostic tools are not well adapted to the SBA; however, other methods are chosen to achieve the same goal (e.g., comparing historical data with potential loss data).

CEBS should either remove these steps, or clearly emphasize that they are "non-exhaustive and non-binding examples".

Similarly, the WGOR questions the utility of Annex V. It may be viewed by some as favoring an LDA approach, and it is highly prescriptive. For example, the sentences: "Nevertheless, where the data result …not sufficiently large" is overly prescriptive and does not account for specific situations where "Maximum Likelihood Estimation" cannot be used because of the paucity of data and where either the "methods of moments" or the "generalized method of moments" could be appropriate and justified. Although the WGOR encourages further discussion on these methodological issues, the working group believes this appendix is too academic, not helpful in this context, and should be removed.

- **AMA Number Validation (par 461(g - h) + Annex VII):** The requirement to "evaluate the accuracy of the capital figures" may be hard to satisfy by "traditional" means since there is no standard concept such as backtesting for market risk VaR that could be applied to the op risk capital figure. It should be made clear that banks should be responsible for coming up with their own reasonable evaluation procedures, which they will have to justify to their primary regulators.

  Similarly, the only bases for "accuracy" are by way of: (i) relevance to historical data (which some banks view as a reflection of chance and not as a risk measure; moreover, it does not necessarily reflect improvements in op risk management or changes in the business which may have occurred since the point in time) and/or (ii) peer comparison (which is problematic because it is not an independent evaluation as all banks may have inaccurate figures in a systematic way).

  The WGOR further recommends that Annex VII should be removed, as it is highly quantitative, standards are still evolving, and it may be difficult for most banks to meet these standards in the near term. For example, the last bullet in Annex VII presumes that banks have calculated their op risk capital many times and are in a position to observe its variability across time. This is not the case at present, as most banks have not yet even begun the parallel run.

  Furthermore, assuming the third bullet refers to the statistical error of the VaR as a result of the estimation error of the parameters, this point may prove difficult to implement at this stage depending on the methodology adopted. This is because: (a) it requires banks to have quantified the relationship between VaR and the model parameters that drive the calculated VaR number, and (b) it presumes that banks have used a parameter estimation method that provides standard errors of the parameter estimates. These assumptions can be fulfilled when adopting an LDA approach based on historical data but is far more difficult for any other type of approach. This makes the point too prescriptive and may not be applicable to some of the methodologies employed by some banks.

- **Holding Period (461j):** CEBS does not explain the reason for the introduction of an internal holding period, which is a requirement beyond that in the CRD and beyond the regular scope of supervisory guidance since it deals primarily with a banks' internal economic capital

calculation. No such supervisory approval of internal calculation methods is justified even under Pillar II, and this requirement should be removed.

- **Observation period (par 461l):** The recommendation in Section 461l to use a historical observation period longer than five years for low-frequency operational risk classes is not covered by the CRD. The WGOR, therefore, suggests deleting Section 461l.

- **Confidence Interval (para 461q-r):** The WGOR supports CEBS' recognition that banks may find it necessary to calculate operational risk capital at a confidence level below 99.9% and then to scale up the number so that it results in a level comparable to a 99.9% standard. However, in order to clarify the standards set out in these two paragraphs, the WGOR recommends that they be combined into the following:

  "In order to generate a regulatory operational risk measure at a soundness standard comparable to a 99.9 percent confidence level, institutions can perform a direct calculation at the 99.9 percent confidence level, or they can calculate an initial measure at a lower confidence level located in the right end of the loss distribution. The institution should be able to demonstrate that the scaling method yields an output that is plausible and reliable. The confidence level used should not necessarily be interpreted as a boundary between the body and the tail of the distribution."

- **Expected Loss (par 461v – w):** The WGOR is pleased to see CEBS endorse the principles-based approach to the treatment of EL that was developed by the Basel Committee's Accord Implementation Group. The WGOR is very supportive of the approaches outlined in paras 461v-w and believes the guidance will be a valuable tool as banks proceed with their own implementation plans and discussions with their national supervisors.

- **Insurance (paras 462g-463):** CEBS should commit to developing reasonable and pragmatic principles to deal with any unintended consequences (such as an increase in capital on the last day of an existing policy) related to the insurance requirements in the CRD. Specifically, the requirement to apply a haircut three months prior to the end of a policy when banks have a clear and well-defined renewal process in place would result in an increase in capital that is not warranted, and the WGOR encourages CEBS to include reasonable principles in line with para 462g of CP10 Revised to address this point.

- **Validation of Data Above Threshold (para 463j):** Section 463j stipulates, "all data above the threshold set must be validated to ensure they are comprehensive, appropriate and accurate." This requirement is hard to understand as it is followed by wording to the effect that banks, after having set low thresholds, are required to validate all loss events exceeding this threshold to be able to use these in a model. However, those losses hardly influence the quantile and therefore the capital measures. This requirement thus merely results in a considerable amount of work, which does not positively influence the quality of the capital measure or of operational risk management generally.

  The WGOR proposes rephrasing this section in the following way "…only material loss events should be validated …".

- **Validation of Risk Measurement Systems (para 463f):** The requirement that "Institutions should ensure that information that is input into the risk measurement systems is as accurate and complete as possible" should be revised to state "….as reasonably practicable." It is not

reasonable to expect 100% completeness and accuracy of data, and CEBS should take a pragmatic view to support reasonable and proportionate standards in this area.

- **Economic Capital (paras 463m and 481):** The WGOR recommends that the term "economic" be deleted from these paragraphs since regulator attention should be on regulatory capital.

D. Additional Comments Related to Operational Risk

- **Partial use (para 417):** In case of partial use of the Standardized Approach (TSA) and Basic Indicator Approach (BIA), institutions are supposed to meet the TSA qualifying criteria for all business lines, regardless of whether a particular business line uses the TSA for its capital calculation. This contradicts the idea of a partial approach, and the WGOR recommends that the qualitative requirements of each approach should also be applied to the corresponding business lines, i.e. compliance with BIA requirements must be sufficient for BIA business lines.

- **Roll Out (para 429):** According to Appendix X, part 4, paragraph 2 of the CRD, national authorities should be able to impose additional requirements for partial use of an AMA (minimum threshold upon introduction and obligation for complete "roll out") on a case-by-case basis. However, para 429 expresses the expectation that additional requirements are to be imposed in "most cases". The CRD provides for permanent partial use as the typical case, even for material units. Consequently, the CEBS proposal cancels out that of the CRD, which is considered inappropriate and should be removed.

- **Data Quality Standards (paras 442 and 445):** The requirement that all loss data above the loss recording threshold "must be validated to ensure they are comprehensive, appropriate and accurate" may be unduly onerous in those cases where a bank has set a low threshold, especially since many of the smaller losses have minimal impact on the capital measures or overall quality of risk management. The WGOR recommends that CEBS redraft this guideline to refer only to validation of material loss events (see also the WGOR's comments on para 463j).

  Furthermore, the WGOR recommends changing the sentence in para 442, bullet 2 to "a review of the systems by which the institution ensures data quality standards." Although cross-checking against material accounting data is cited as an example of activity aiming to improve the data quality standards, in para 442 regulators set as a minimum standard for internal audit to review the system for cross-checking against accounts. This effectively turns the example into a requirement, and the WGOR believes it should remain as an example only.

- **Data Documentation (para 448):** Overall, the WGOR views the requirements of para 448 regarding data documentation as unduly prescriptive. For instance, database descriptions and statements of IT system weaknesses do not contain any additional information about the accuracy of the data used. Therefore, we suggest streamlining these bullet points into some high-level principles.

- **Internal Governance (para 466):** The word "passively" is misplaced here and should be deleted. Banks actively engage in business that they recognize will generate operational risks; indeed all business entails operational risk of one sort or another.

- **Hierarchy of Responsibility, Management Body and Senior Management**

    - **Para 470:** The WGOR recommends that this paragraph be rephrased to reflect a more realistic view of the role of the management body vis-à-vis the operational risk framework. The WGOR suggests that CEBS revise the second sentence accordingly: "They should have …a good comprehension of the operational risk reports submitted to them and general understanding of how operational risk affects the institution."

    - **Para 473**: Though the WGOR shares the objective of ensuring that "the overall risk management and measurement processes and systems remain effective over time", the working group is concerned that this paragraph could question the independence of Internal Audit and, to a minor extent, the ORM function.

      As a result, the WGOR recommends the following wording: "The operational risk management function and Internal Audit should work, on a ongoing basis, in close cooperation with senior management, to ensure that their control procedures and measurement systems are adequate and that the overall risk management and measurement processes and systems remain effective over time." At the very least, it should be clarified that only the "management body" has proper oversight of procedures and systems adopted by Internal Audit.

    - **Para 474:** Though the tasks listed in this paragraph are appropriately under the responsibility of senior management, the WGOR believes that the ORM function should be associated with, and be held partly responsible for, these tasks.

      The WGOR would then suggest: "Senior management should ensure, in cooperation with the appropriate level of the ORM function, that the following tasks are being addressed."

      Moreover, the WGOR recommends that para 474 reference a "phasing in" of this list of tasks, as compliance with all of these standards will be an ongoing goal of institutions but may not be possible within the remaining timeframe before implementation.

IV. 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.

Appendix A

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

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.

[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.

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 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.

APPENDIX B

High-Level Principles for Validating Correlations

The WGOR proposes some high-level principles for validation of correlation frameworks. This type of principles-based approach would be consistent with the underlying flexibility and philosophy of the AMA that allows banks to develop their own internal models. It is also consistent with the view that banks must have primary responsibility for model validation.

It should be underscored, however, that "validate" does not mean to verify in a strictly statistical sense. Relying solely on statistical validation is considered inappropriate because there is insufficient data for doing so, and in most cases, alternative approaches to confirm the reasonableness of assumptions may be required (e.g., a check for management reasonableness needs to be applied). In order to have sufficient data to be able to validate its correlation assumptions statistically, a firm would probably have to incur a significant increase in the number of tail events.

Therefore, it is more appropriate to focus validation principles on the correlation *framework* used to derive estimates rather than on the correlation *estimates* themselves. Principles for use and validation of correlation frameworks in AMA models could include the following:

- **The recognition of correlations must be consistent with the overall AMA methodology and structure.**
  As correlations are embedded within the AMA methodology, the manner in which they are assessed and incorporated within the model must be consistent and coherent with the overall model itself. This includes the consideration of the effect of correlation in the aggregation across the risk assessments made at granular level (e.g., across the 56 cell, or across risk scenarios).

- **Correlation assumptions must be justifiable.**
  As part of their correlation frameworks, banks must justify their correlation assumptions and the incorporation of such assumptions into the AMA model. This process can include a combination of qualitative and quantitative approaches. However, it should be recognized that, in many cases, it may not be possible to statistically test or verify correlation estimates and alternative approaches to confirm assumptions may be more effective. A management check for reasonableness is an important part of this process.

- **Correlation assumptions and estimates must be transparent and appropriately documented.**
  A bank must have a clearly defined and documented process in place for incorporating and assessing any correlations within an AMA model. This includes any rationale to support the framework, and any estimates made.

- **Correlation assumptions should be regularly reviewed for ongoing validity.**
  Any correlation assumptions (including correlation estimates) should be reviewed on a periodic basis to ensure that they are still valid and reasonable. Furthermore, correlation assumptions, and any changes made to these assumptions, should be subject to review by internal audit, or some other independent body other than the operational risk unit.