European Association of Public Banks
- European Association of Public Banks and Funding Agencies -

via e-mail:
CP10rev@c-ebs.org

Brussels, 14 February 2006

EAPB Position Paper on the 2nd Draft of CEBS' "Guidelines on the implementation, validation and assessment of Advanced Measurement (AMA) and Internal Ratings Based (IRB) Approaches"

The European Association of Public Banks (EAPB) represents the interests of 20 public banks, funding agencies and associations of public banks throughout Europe, which together represent some 100 public financial institutions with a combined balance sheet total of about EUR 3,000 billion and more than 173,000 employees, i.e. representing a European market share of approximately 10%.

The EAPB would like to thank CEBS for the opportunity to comment on CEBS' 2nd draft of "Guidelines on the implementation, validation and assessment of Advanced Measurement (AMA) and Internal Ratings Based (IRB) Approaches".

1. General remarks

The EAPB welcomes CEBS' objective of promoting a common understanding of the minimum requirements for the IRBA and AMA among European supervisory authorities in order to facilitate the use of the cooperation procedures under Article 129 (2) of the CRD and bring about a consistent application of rules and a convergence of supervisory practices in the EU. In our view, however, the draft guidelines still fail to carry out this intention in an appropriate manner.

A basic principle in creating a single market is to achieve minimum harmonisation in areas of particular relevance to competition. This reflects the principle of subsidiarity and must not be turned into its opposite – namely detailed maximum harmonisation.

Although the EAPB welcomes the "good faith clause" in principle, the inclusion of the new Section 14 a means that full harmonisation is firmly established for the areas covered by the guidelines. Section 14 a does not accept any deviation from the guidelines over time. Against the background of the guidelines' high level of detail and requirements that are often not

practice-oriented, this is not acceptable. The provision moreover contradicts the principle of proportionality, for all institutions are subject to the guidelines.

National supervisory authorities must continue to have sufficient discretion on matters of detail so that account may be taken of national specificities when transposing European directives. The consistent application of directives and the convergence of supervisory practices in the EU should not lead to a high level of detail and a disproportionately costly additional administrative burden for financial institutions, particularly small banks. This applies all the more in view of the fact that the majority of European banks operate only at national level and benefit from convergence of regulation and supervisory practices at best indirectly. The costs imposed by the high level of regulation also put all EU banks at a disadvantage compared with banks based outside the EU. As far as we know, the Basel Accord Implementation Group is not planning to publish anything similar to the CEBS guidelines

It should, moreover, be ensured that the guidelines do not give rise to rules going beyond what is required under the CRD since the Lamfalussy process gives CEBS no mandate to call into question, let alone modify, democratically legitimated decisions. This applies particularly to areas where European legislators have consciously and for good reasons not adopted some of the Basel framework's more restrictive requirements so that solutions can be implemented in the banks which reflect market realities.

In their present form, the proposed guidelines

- contain a high degree of detail - in some cases without offering additional clarification,
- are sometimes inconsistent concerning definitions and requirements,
- add requirements going beyond the CRD,
- are sometimes not in line with common modelling techniques or simply impracticable (see in particular remarks on Section 462a)
- are frequently mathematically unfeasible.

The guidelines should be limited to high-level principles on major issues that are relevant to ensuring a level playing field. Supervisors ought to focus on targets that should be met within the approval process, instead of prescribing detailed steps which will probably impose an additional burden on both supervisors and banks without achieving CEBS' stated objectives.

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2. Specific remarks

Chapter 1 – Introduction

Section 14 b

We welcome the intention to adapt the guidelines in line with the development of the industry standard in the field of AMA and IRB approaches. However, we should like to request, by way of precaution, that reasonable transition periods be allowed for any changes to the guidelines.

Section 15 a

Although Section 15 clarifies the scope of application of CP10, the question of EU-Non-EU arrangements remains unanswered and needs clarification

Chapter 2 – Cooperation procedures, approval and post approval process

Section 58

The requirements regarding the "implementation plan" exceed requirements laid out in some member states (e. g. Germany). In line with the "good faith clause" (Section 14 a) it should therefore be clarified that no legal consequences are imposed on those institutions whose IRBA application has already been launched on the basis of national IRBA application regulations.

Chapter 3 – Credit Risk

Section 187 f

It is intended to clarify that an originator who fails to transfer significant credit risk has to "keep the securitised exposures under the retail and corporate exposure class". This is misleading since in principle exposures from every exposure class can be securitised. We therefore would like to suggest stating instead that the originator will have to calculate risk-weighted exposure amounts for the securitised assets according to the rules for the "respective exposure class".

Section 187 r et seqq.

We reject the *de facto* adoption of the Basel Accord definition of "equity exposures" for the EU. The definition in Article 86 (5) should be kept instead as it already laid the foundation for national implementation in several member states. A less rigid definition gives flexibility to institutions to establish adequate criteria and processes to delineate between credit and equity exposure. This flexibility reflects the general Pillar II idea of proportionality and gives flexibility to efficiently respond to changes in the market environment.

Products with debt- and equity-characteristics (e.g. mezzanine) 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 judgement regarding these products takes several dimensions into account to determine the degree of equity (see for example "Moody's Toolkit: A Framework for Assessing Hybrid Securities", Dec. 1999, which analyses products along the dimensions "maturity", "loss absorption" and "No ongoing Payments" to place these on the "debt-equity continuum") which are not static. The proposed mostly one-dimensional guidelines are not suitable for this purpose and might interfere with market developments (e.g. missing maturity – Section 187 u (1)). Therefore, these criteria should not be introduced via CP10.

To prevent "gaming", banks should be asked to introduce transparent and auditable internal processes and criteria for the classification of debt and equity products.

The inclusion of indirect equity exposures, i.e. "holdings in corporations, partnerships, limited liability companies or other types of enterprise which issue ownership interests and are engaged principally in the business of investing in instruments" is, moreover, unclear. This poses problems particularly under an individual entity-level approach. If, for example, holdings in "financial enterprises" (Art. 4 no. 5 of Directive 2000/12/EC) are not deducted from equity, the holdings of the financial enterprise would have to be treated by the bank in the IRBA within the framework of a "look-through" approach. We reject this, as the bank's loss is limited to the amount invested in the financial enterprise. The "look-through approach" would, moreover, constitute an additional "partial consolidation" that is not offset in supervisory terms by any gain in knowledge going beyond group reports.

Section 187 u

At first glance, all instruments with the same structure as an instrument accepted by banks as Tier 1 capital are to be included as equity exposures. We should like to point out in this connection that the term "Tier 1 capital" does not appear in Directive 2000/12/EC. Reference should be made instead to the capital components in Article 57 a)-c) of Directive 2000/12/EC.

According to the second bullet point (1) an instrument should be categorised as equity if the issuer may defer indefinitely the settlement of the obligation. From our point of view, 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 single features. According to Moody's analysis, for example, perpetual preferred securities can be closer to credit than to debt depending on

other features of the product. (see "Refinements to Moody's Tool Kit: Evolutionary, not Revolutionary!, Feb 2005, p.6).

Section 187 x

We reject the CEBS's proposal to assign convertible bonds to the equity segment. Since the conversion of the bond into shares/equity is only an option, the exposure should be treated as any bond, as long as the option is not exercised. Only after conversion of the bond into shares would the exposure be assigned to the equity segment.

Section 188 et seqq.

The criteria governing the use of certain approaches for the treatment of exposures are described adequately in Annex VII, Part 1 No. 15. Additional criteria ("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") should not be introduced.

Sections 219 a-b und 239 a-d

The Sections 219a and b, 239a to d are in essence excerpts of the Basel Committee's „Guidance on Paragraph 468 of the Framework Document". However, the clear statement (Section 115, p. 10) in favour of banks: "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" should be included. Moreover, statements like "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." (in Section 239a) open the door to regulatory arbitrariness.

Section 239 a (1)

Identifying appropriate downturn conditions for the entire portfolio on the basis of internal empirical data is highly unrealistic. Even more unrealistic is identifying downturn conditions for each supervisory asset class and each jurisdiction since the number of defaults and recovery proceeds for several asset classes/jurisdictions is very small.

Section 306

This paragraph 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. This process could mean unnecessary duplication of data preparation (original *and* sample data has to be prepared; the later is checked by the supervisor). No duplicate data preparation should be required for supervisory review purposes.

Section 312

This paragraph states that institutions should demonstrate the comparability of data sets by means of analyses of the population of *exposures.* This requirement raises practicability issues since exposure information is generally not provided with ratings of ECAIs or pools.

Section 340

We would like to point out that there is an inconsistency between specific guidelines set out in Section 340 and more general principle guidance (principle 5, Section 333): Section 340 states that institutions should take action if internal validation thresholds (i.e. derived from confidence intervals) are exceeded; thus, Section 340 could be interpreted as “hard” thresholds for backtesting. 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 backtesting or benchmarking results (as set in Section 340) contradict principle 5.

Section 360

It should be clarified that for small institutions an adequate control process is sufficient and no separate organizational unit is required.

Chapter 4 – Operational Risk

May we point out that there are many paragraphs which do not contain any rules in the real sense but are more of a descriptive nature and achieve a level of detail that is out of place in supervisory regulation. We would refer in this connection particularly also to the whole of Annex V, whose purpose is unclear to us. It is not the job of a supervisory authority to provide examples of operational risk modelling. We wish to stress again that experience shows that so-called examples are interpreted as more or less mandatory best practices. For this reason, we are in favour of dropping Annex V in its entirety.

Section 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, Section 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 the purpose of the CRD, is not covered by the CEBS mandate and should be dropped.

Section 445

Regularly cross-checking material accounting data against operational loss data is unnecessary and also uncustomary in practice as the material loss data already have to be cross-checked against the accounting data (see Section 442). On the contrary, such an additional requirement imposes a burden that is in no proportion to the result (supposedly broader coverage of loss events). We also wish to point out that this is an additional requirement on top of the CRD, as it has no equivalent in the directive. We are therefore in favour of dropping this requirement.

Section 448

In our view, the requirements of Section 448 regarding data documentation are inappropriate. Database descriptions und statements of IT system weaknesses do not contain any additional information about the accuracy of the data used. Therefore, we suggest dropping the requirements regarding database descriptions and statements of weaknesses.

Section 456 j

According to the first sentence in Section 456j, losses and recoveries stemming from insurance policies should be recorded separately in the database. We would suggest 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. We therefore suggest deleting the lines in question.

Section 456 l

The development of procedures to detect incidents or near misses is not addressed in the CRD and is thus an additional requirement. We reject such a requirement.

Section 456 n

All examples describe the assignment on a loss-event level. Is it intended to rule out other possibilities? If not, the following example could be amended: Capital figures calculated for a centralised function can be assigned to the affected business lines in a well-documented way.

Section 456 p

The content of Section 456 p is purely descriptive and is not a precise requirement. Furthermore, it is not dealt with in the CRD. We therefore suggest deleting it.

Section 456 z

The scenario analysis is normally used for obtaining figures for tail events; the intention in Section 456 z seems to be establishing scenarios for "normal" events. This interpretation is at odds with the basic intention of scenario analysis, which is for scenarios to replace missing data points in the tails. This point should therefore be deleted.

Section 457 a

We should like to stress that it is simply not possible to prove the granularity or granularity assumptions regarding the number of scenarios in a statistical analysis. We suggest deleting Section 457 a.

Section 461 c

According to Section 461c, loss events and loss amounts within operational risk classes should be independent and identically distributed. 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, which needs to be justified. "*

Section 461 i/j

The reason for the introduction of an internal holding period is not explained. This only creates additional complexity. We would also point out that the CRD does not contain any rules whatsoever on this, so that an additional requirement is again being created here. Finally, we wish to add that no such supervisory approval of internal calculation methods is justified even under Pillar II. It should therefore be removed.

Section 461 l

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. We therefore suggest deleting Section 461 l.

Section 462 a

Section 462a calls for the AMA capital charge to be calculated as at least the sum of the individual risk measures. This already very conservative calculation method is only possible, it states, if it can be demonstrated that dependencies of tail events are not underestimated. It can be concluded from this that the existence of dependencies of tail events is regarded as a frequent phenomenon.

The consequence of this requirement is that the central idea of reducing risk through diversification is ruled out for the AMA. Such a premise therefore means that AMA modelling cannot produce any more risk-sensitive result than a calculation under the Standardised Approach. This cancels out the effect of the key Basel principle of the "continuum of approaches". The assumption underlying the requirement, namely that a possible existence of dependencies of tail events is not already covered by the total value at risk, is merely inferred mathematically in the leading academic literature[1] . There is absolutely no proof of its practical relevance. A supervisory rule must, however, cover normal cases and not simply anticipate purely theoretical phenomena. It should also be pointed out that dependencies of tail events can only occur in the case of quantiles of over 99.9%. However, the supervisory discussion only revolves around quantiles of 99.9%, so that this requirement cannot therefore have any relevance for the AMA.

Last but not least, we would refer to the supervisory requirement that losses with the same cause must be grouped to one single data point, which is – again – an argument that tail events should not show any dependencies.
For these reasons, we request deletion of Section 462a as well as Annex VIII.

Section 463j
"Section 463 j stipulates that 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 bureaucracy, which does not positively influence the quality of the capital measure. We propose rephrasing this section in the following way "…only material loss events should be validated …".

[1] *Embrechts, P./Puccetti*, G. (2005): „Aggregating Risk Capital, with an Application to Operational Risk".