POLISH BANK ASSOCIATION

Kruczkowskiego 8, PL 00-380 Warsaw, phone: +48 22 48 68 180, +48 22 48 68 190, fax +48 22 48 68 100, e-mail: info@zbp.pl, www.zbp.pl

EBA/CP/2014/08

Warsaw, 9 Sept. 2014

Ref. Polish Bank Association response on "Consultation paper on Draft Regulatory Technical standards on assessment methodologies for the Advanced Measurement Approaches":

The PBA welcomes the opportunity to express the view of the Polish banking industry on the EBA consultation paper on draft regulatory technical standards on assessment methodologies for the Advanced Measurement Approaches (AMA) for Operational Risk under article 312 of the capital requirements regulation (EU) No 575/2013.

In response to EBA/CP/2014/08 on June 12, 2014 Polish Bank Association pass the following remarks to this draft RTS :

Overview of questions for Consultation:

Q1: Are the provisions included in these draft RTS on the assessment methodologies for the Advanced Measurement Approaches for operational risk sufficiently clear? Are there aspects that need to be elaborated further?

The provisions included in the draft RTS on the assessment methodologies for the Advanced Measurement Approach for operational risk are not in all areas sufficiently clear and some of them need to be reformulated. Detailed remarks and commentaries are in Appendix below.

Q2: Do you support the treatment under an AMA regulatory capital of fraud events in the credit area, as envisaged in Article 6? Do you support the phase-in approach for its implementation as set out in Article 48?

No, we do not support the treatment under an AMA regulatory capital of fraud events in the credit area, as envisaged in Article 6.
Sometimes it is extremely difficult to distinguish "first party" fraud from other reasons of client's default. For instance a customer intending to commit a fraud will pay for the first installment of his loan in order to better conceive the fraud. But also an honest customer

will also pay for his first installment before his credit capacity will deteriorate. So without a deep analysis of the customers file it is impossible to discover the fraud. This could lead to the regulatory capital arbitrage – ambiguous cases of frauds could be included in AMA or IRB depending on the needs of a bank or which approach is most convenient to a bank.

Secondly, no convincing arguments were provided to use LDA or Scenario-based approaches to model credit risk losses. Moreover, an institution may, as a part of its strategy, willingly accept an increased level of external frauds in order to reduce the cost of granting loans and speed up the credit process. A natural consequence will be an increased interest rate or fees level paid by the creditors. This increased probability is taken into account by the increased value of the PD parameters. In such a case the risk of fraud events looks more like an ordinary "credit risk".

This change will require substantial modification of the AMA and IRB framework, which should also be considered by EBA before changing the rules. . No evidence was provided that the implementation cost will be offset by the benefits of taking account of "first" or "third party" frauds into operational risk models. Operational risk and credit models were calibrated. The change will alter previous calculation of the PD and LGD parameters.

Finally, adding fraud events into AMA calculation will require a wide analysis conducted by EBA in order to assess the global impact of the proposal on the capital burden on the banking sector. Results of this analysis should be made publicly.

Q3: Do you support the collection of 'opportunity costs/loss revenues' and internal costs at least for managerial purposes, as envisaged in Article 7(2)?

We support the collection of 'opportunity costs/loss revenues' and internal costs only for managerial purposes.

Q4: Do you support the items in the lists of operational risk events in Articles 4, 5 and 6, and the items in the list of operational risk loss in Article 7? Or should more items be included in any of these lists?

Yes, we do support the items with the exception of collecting opportunity costs/lost revenues. In general, opportunity cost require making assumptions and conducting estimations, which leads to subjective values and high workload. Details are provided in Appendix below.

Kruczkowskiego 8, PL 00-380 Warsaw, phone: +48 22 48 68 180, +48 22 48 68 190, fax: +48 22 48 68 100,
Nip: 526 000 09 91, PKO Bank Polski SA XV Oddział Centrum 02 1020 1156 0000 7202 0008 6215

Q5: Do you support that the dependence structure between operational risk events cannot be based on Gaussian or Normal-like distributions, as envisaged in Article 26 (3)? If not, how could it be ensured that correlations and dependencies are well-captured?

If a bank uses a copula function to capture correlations and dependencies, it should be able to prove the adequacy of this function to the empirical evidence.

Q6: Do you support the use of the operational risk measurement system not only for the calculation of the AMA regulatory capital but also for the purposes of internal capital adequacy assessment, as envisaged in Article (42)(d)?

Generally, we do. However we suggest the EBA to elaborate more to which extent the AMA model has to be used for ICAAP purposes.

Kruczkowskiego 8, PL 00-380 Warsaw, phone: +48 22 48 68 180, +48 22 48 68 190, fax: +48 22 48 68 100,
Nip: 526 000 09 91, PKO Bank Polski SA XV Oddział Centrum 02 1020 1156 0000 7202 0008 6215

Appendix to Q1

Article 1(2)

The term "model risk" is not defined. Institutions use different types of models like: macroeconomic models, capital calculation models, valuation models (like valuation of financial instruments), models related to the bank's exposure to different types of risks, business models, etc. Even if errors of these models nearly always lead at least to suboptimal decisions and allocation of resources, only for some of them banks are really able to gather robust evidence of incurred losses or lost opportunities. We suggest 1) to give an explicit definition of model risk (like the provided definition of legal risk),
2) to clearly address the question of the list of models.
A paragraph devoted to losses (being a consequence of these model flaws and to be included into AMA calculation) will make the document much clearer. From articles 4(5), 5(2), 5(5) we understand that at least part of these losses should be excluded. But these paragraphs do not address all the issues. For instance should direct and indirect losses (caused by an erroneous model used to assess the capacity of clients to fulfill their obligations) be included into AMA calculation?

Article 4
Point 3(c). Discounts of future services in our opinion are lost revenues and should be excluded from AMA calculation of regulatory capital.

Article 5

The expression "errors during the introduction or execution of orders" should be explained. What kind of orders are mentioned in (3(a))?
3(b) is not clear. What kind of classification is this point referring to?
E.g. point 3(g). Unauthorized market positions taken in excess of limits should be used for AMA calculation only if they cause financial impact (loss or gain). According to Article 7 point 2(b) operational risk gains are required only for AMA management purposes but not for calculating AMA regulatory capital.

Article 7

Point 1(e). Uncollected revenues related to contractual obligations such as the decision to compensate a client is mostly a business decision and as such cannot be directly related to

Kruczkowskiego 8, PL 00-380 Warsaw, phone: +48 22 48 68 180, +48 22 48 68 190, fax: +48 22 48 68 100,
Nip: 526 000 09 91, PKO Bank Polski SA XV Oddział Centrum 02 1020 1156 0000 7202 0008 6215

operational loss. A Contractual fee for a specific future period of time is a lost revenue and should be excluded from calculating AMA regulatory capital.

In our view there is no justification to collect full scope of information from section 2 because of the quality of information related to:

- "opportunity costs" from p. 2 (c) would be insufficient due to the inability to verify the entered data (lack of corresponding objective source of data such as financial books). Moreover, taking into account efforts to update and validate this information, the cost of capturing relevant information would be excessive comparing to the improvement in knowledge for risk management purposes.

- „internal costs such as overtime or bonuses". from p. 2 (d). In our opinion, obtaining information on "overtime costs" resulting from operational events is difficult. The argument for excluding such data is that it is tough to indicate a clear boundary that relate to overtime to repair the effects of events, which are already linked to the introduction of improvements in the process.

Article 8

Point 1(d). We suggest not collecting data about interests for calculating AMA regulatory capital because they are lost revenues.

Article 17(1)

Comparable quality, scope, integrity and comprehensiveness of external data to the internal data standards envisaged in Article 16 are not possible. External databases have in general lower standards than internal databases of AMA banks, hence it is better to request institutions to do their best to ensure that the quality, comprehensiveness of used external data fulfills the standards set out in Article 16.
The reasons are:

1) external data can have not the same granularity as internal data,
2) description of events is too vague to permit checking the allocation of these data to different risk categories or business lines,
3) name of the institution is in general hidden, which limits the possibility of proper scaling external data to bank's profile.

Kruczkowskiego 8, PL 00-380 Warsaw, phone: +48 22 48 68 180, +48 22 48 68 190, fax: +48 22 48 68 100,
Nip: 526 000 09 91, PKO Bank Polski SA XV Oddział Centrum 02 1020 1156 0000 7202 0008 6215

4) the consortium parameters to scale events do not permit to do it properly (insufficient number and quality of scale parameters),
5) reporting thresholds used by consortia are in general higher that the internal data thresholds used for modeling. As a consequence adding external data caused a decline of the parameter "probability of observability" often worsening the statistical properties of the frequency and severity distribution parameters. It may also increase the probability of an incorrect selection of the distribution or fitting of its parameters,
6) banks do not report all data above thresholds to consortia (data hidden or reported with abnormal delays).

Article 21(7-9)

We strongly disagree with the article. The proposed approach is event-centric and is tending to provide the maximum figure for operational risk results. However:

1) Grouping all incurred losses into a single one makes the reconciliation of recorded loss amounts with accounting data more difficult,
2) Grouping may create distortion. Let's consider the following operational risk events:

	Event 1	Event 2	Size of the bank
Size of the loss in year 1 in EUR	80,000	20,000	S
Size of the loss in year 2 In EUR	20,000	80,000	S+ΔS

The first event is more severe that the second one as the analyst has to take into account the cost of money/cost of capital and the size of the bank (scaling factor for operational risk events and losses).

3) Grouping data could falsify estimates of frequency and severity of losses and events. Let us suppose an event with losses spread over a long time period (from year "t" to year "t+n") – which often happens to legal cases. If the bank uses an "n" year observation period for AMA calculation, in year "t+n+1" it will face the following dilemma. Either it will keep the event in the observation period by changing the "accounting date" or it will artificially add the event to the new observation period. In any case the frequency of events will be increased by one

Kruczkowskiego 8, PL 00-380 Warsaw, phone: +48 22 48 68 180, +48 22 48 68 190, fax: +48 22 48 68 100,
Nip: 526 000 09 91, PKO Bank Polski SA XV Oddział Centrum 02 1020 1156 0000 7202 0008 6215

and the tails of the severity distribution will be made without any reason too thick. Moreover the "n" year reference period will now be an illusion. The second possibility partially addressing the above problem is to include the event only for assessing the severity of events. So there will be 2 different data sets: one used for determining the severity distribution and the second used to determine the parameters of the frequency distribution. If there are any data threshold the bank will also have to use a severity distribution to assess parameters of the frequency distribution. Needless to say that the 2 severity distribution may substantially differ. This solution is still not acceptable.

4) Grouping all losses in a single one could create instability of the dataset. The same observation will have different values in time. That is in period 1 for instance value "x", in period 2 value "x+δx", in period 3: value "x+ δx+ δ'x". As updating past events may change severity distributions and their parameters the analyst should make a very deep and tedious analysis in order to determine whether the real reason of changes of the distribution and its parameters were caused by new events, updating past events or mutual influence of updating past events and adding new events.

5) Grouping data reduces the stationarity of losses.

So we propose to group all losses caused by a common operational risk event or by multiple events linked to a single root-event but only if they have occurred in the same time period. By doing this, changed articles 21(8) and 21(9) would be useless. By the same time period we understand the same month or quarter (depending on the frequency of the AMA calculation). Moreover this solution will facilitate the reconciliation of loss data used for calculation with and the posting of losses into the banks books.

Article 22

Reducing the number of segments is sometimes the easiest way to reduce the capital requirements for operational risk as all observations belonging to the same cell are supposed to be independent. The requirements set out in article are too general. Perhaps RTS should propose a compulsory minimum level of granularity.

Kruczkowskiego 8, PL 00-380 Warsaw, phone: +48 22 48 68 180, +48 22 48 68 190, fax: +48 22 48 68 100,
Nip: 526 000 09 91, PKO Bank Polski SA XV Oddział Centrum 02 1020 1156 0000 7202 0008 6215

Article 23(6)

Some distributions have no moments for specific values of parameters. We suggest instead promoting distributions with right tail well fitted to data. The conformity of moments is a plus but is not necessary in our view.

The article does not address the question of the selection of frequency distribution. In our opinion Poisson, binomial distributions rarely properly describe the frequency of losses and events. So we suggest that the competent authority should assess the goodness-of-fit of the frequency distribution and if necessary recommend using negative binomial, (a,b,1), mixed or compound distributions.

Article 24(4)

In order to simulate a loss under a Monte Carlo simulation, an analyst (or the computer) must calculate $F^{-1}(x)$. However, if the selected value for the distribution is equals to one (or close to one) the corresponding value of x will be infinity (or an extremely large number). Some computer programs (e.g. SAS) request analysts to provide for this technical reason a maximum single loss cap.

We suggest that instead of using techniques in order to avoid capping losses, the institution should justify the amount of the single loss cap. For instance a DPA loss cannot be greater the sum of all bank's assets.

We do not agree with (ii)(b). Let us note, that existence of the first moment could depend on parameters of applied distribution. The most important thing is to select a distribution which is fitted to data. It will be better to select a distribution correctly fitted to data even without moment that to use a distribution with moment but with a tail unfitted to data. We propose to soften the requirement by asking the institution to prefer distribution with moments.

Article 25(3)

The point is that median or trimmed mean are not appropriately sensible to addition of a single high loss. Both measures have the central tendency and are not sensitive to extreme loss values. However, an institution should take into account the existence of these losses in assessing the expected losses.
Because of it, defining EL as a mean seems to be a better choice. The amount that could be deduced should be the minimum of the EL and size of provisions and impairment created in order to offset operational risk losses.

Kruczkowskiego 8, PL 00-380 Warsaw, phone: +48 22 48 68 180, +48 22 48 68 190, fax: +48 22 48 68 100,
Nip: 526 000 09 91, PKO Bank Polski SA XV Oddział Centrum 02 1020 1156 0000 7202 0008 6215

Article 32(1)

Article says that before ORTM instruments can be recognized in the institution's operational risk measurement system, the component authority shall verify that an institution has experience in using ORTM instruments. Today, ORTM instruments are only in their infancy and a lot of institutions are not using them. As they have no experience they will also not used ORTM in the future (because they will have cost without any financial or capital incentive). We think that a better solution is to impose conditions to the use of ORTM instruments broadly similar to the use of insurance instruments.

Kruczkowskiego 8, PL 00-380 Warsaw, phone: +48 22 48 68 180, +48 22 48 68 190, fax: +48 22 48 68 100,
Nip: 526 000 09 91, PKO Bank Polski SA XV Oddział Centrum 02 1020 1156 0000 7202 0008 6215