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Association for Financial Markets in Europe

Consultation Response

Consultation on Technical standards on the new Business Indicator framework for operational risk (EBA/CP/2024/05)

21/5/2024

The Association for Financial Markets in Europe (AFME) welcomes the opportunity to comment on **Consultation on Technical standards on the new Business Indicator framework for operational risk (EBA/CP/2024/05)**. AFME represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. We advocate stable, competitive, sustainable European financial markets that support economic growth and benefit society.

AFME is the European member of the Global Financial Markets Association (GFMA) a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association (ASIFMA) in Asia.

AFME is registered on the EU Transparency Register, registration number 65110063986-76.

We raise an additional consideration regarding the timeline for calculation of the operational risk capital requirements, which is followed by answers to the individual questions raised.

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Overarching comments

AFME and its members have provided answers to the EBA's specific questions below. However, we would also like to highlight an issue regarding the timeline for calculation of the operational risk capital requirements. With reference to section 3.4 of the consultation - the "annual average over the last three financial years", by means of example, works as follows:

- at 30/09/2025 the previous three years (being 2022, 2023 and 2024) are the basis of the calculation; and
- at 31/12/2025 the relevant years would shift to 2023, 2024 and 2025.

However, the draft RTS also states that the calculation shall be based on N-1 to N-3 "audited financial statements". By the time we report COREP templates in Q1-2026 (reference date 31/12/2025), banks' financial statements may not have yet been audited. Based on these considerations, respondents strongly ask to report data as of 31/12/N-1 for all remittances of the year (i.e., from Q1 to Q4). This would allow institutions and supervisors to have consistent audited figures over the same calendar year. This means that the data as of year N will be used in full starting in Q1 of the year N+1, up to the Q4 of N+1.

We provide below our responses to the questions set out in the consultation paper. We thank you in advance for your consideration and please do not hesitate to contact us with questions or if you would like to discuss our recommendations further.
Yours sincerely,

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Questions:

Question 1: What are your views with regards to the proposal for the ILDC component? Please explain and provide arguments for your answer.

AFME and its members have the following comment related to the concepts of "total assets" and "carrying amount":

1. Asset component (Article 3 of the RTS on BI items) (p. 34)

- The described "total assets" comprise gross carrying amount positions and carrying amount positions. However, total assets are defined as carrying amount. In order to deliver reliable data, all required positions which relate to template F18.00 should include column 0130 "accumulated impairment".

2. Interplay between ILDC, FC and "clean price"

Regarding the determination of the ILDC component and the Financial Component, it appears that institutions using the so called "clean price" to produce the FinRep reporting may be penalized compared to institutions using the "dirty price" approach, unless the impact is neutralised for the purposes of the BI calculation. As a reminder, the clean and dirty price approaches are described in Instructions for FinRep reporting (Annex 5) as detailed bellow:

"Interest income and interest expense from financial instruments measured at fair value through profit or loss and from hedging derivatives classified in the category 'hedge accounting' shall be reported either separately from other gains and losses under items interest income' and 'interest expense' ('clean price') or as part of gains or losses from these categories of instruments ('dirty price') (...)

'Interest income. Financial assets held for trading' and 'Interest expenses. Financial liabilities held for trading' shall include, where the clean price is used, the amounts related to those derivatives classified in the category 'held for trading' which are hedging instruments from an economic but not accounting point of view to present correct interest income and expenses from the financial instruments that are hedged (...)

Dividend income on equity instruments measured at fair value through profit or loss shall be reported either as 'dividend income' separately from other gains and losses from those classes of instruments where the clean price is used, or as part of gains or losses from those classes of instruments where the dirty price is used".

Institutions using the clean price approach reclassify interest income & expenses and dividend incomes from gains and losses from instruments held for trading or instruments designated at fair value through profit or loss to interest incomes & expenses and dividend income within F02.00. This does not constitute an accounting choice or method but a reporting reclassification. These reclassifications are made for FinRep reporting purpose only.

However, in a situation where the P&L of the trading book of an institution would be negative, this reclassification would result to: i) deepen the loss of the P&L of the trading book and ii) increase the amounts of dividend incomes (as for example dividend revenues stemming from equity instruments measured at FV in Trading book would be reclassified in dividend income).

That will mean that without adequate adjustments, institutions using clean price approach for FinRep would be penalised under the SA-OR compared to institutions using the dirty price approach as, considering the same P&L profile, in case of negative P&L of the trading book, one institution using clean price would see its FC (based on absolute value) increased by the amounts related to dividend revenues or net interest and its ILDC increased by the same amount, while others using dirty price would not suffer from this effect.

We consider that institutions using clean price approach should not be penalized in this way and ask the EBA to allow institutions to neutralize the negative impact of the reclassification made for FinRep purposes (with the same reclassification mechanism that the one used for AA to PBA approach but allowing reclassification of dividend revenue and interest incomes/expenses from ILDC to FC).

Question 2: What are your views with regards to the proposal for the Services component? Please explain and provide arguments for your answer.

With regards to the Other Operating Expenses component, the RTS specifies that all financial impacts linked to operational risk events need to be added to this item. This needs to be done independently from the initial accounting aggregation, where they were initially recognised. As mentioned in the text, the relation between the operational risk event financial impact and the corresponding accounting aggregation is not straightforward, and maintaining such correspondence as the RTS requires, with comprehensive information on where the impacts of operational risk events are accounted for in the P&L statement will be very complex if not impossible to achieve. It requires duplicating any accounting entries between the ones linked to operational risk and those that are not. Furthermore, such requirement is not included in the Level 1 text which only requires to measure the operational risk losses (art 315(3)). It seems from the industry's perspective that this proposed requirement is not proportionate and mandated in what the level 1 text intends to achieve.

In a broader context, AFME and its members strongly believe that the services component has been mis calibrated by the Basel Committee of Banking Supervision. This is because the SA-OR requires banks to hold capital against fee and commission-based activities – such as retail brokerage, investment advisory services, custody, and client clearing. The treatment of fee-based income under the SA-OR has adverse effects on particularly on the capital markets activities by over-calibrating capital requirements for relatively low-risk services, potentially raising costs for both retail and institutional investors. AFME encourages the EBA and its international counterparts to review the calculation methodology for the services component.

The Consultation's Services Component (3.2.2) is calculated based on the gross amount of four components: other operating income, other operating expenses, fee and commission income, and fee and commission expenses. We acknowledge that operational risk is inherent across many banking products, activities, processes, and systems. However, we believe the services component should be amended to better reflect the risks associated with such activities.

As per EBA/CP /2024/05, the ILDC is made up of three components (i.e. the interest and leases component - IC, the asset component – AC and the dividends component - DC) and is calculated according to the minimum of 2.25% of the AC or the IC.

In contrast, the services component is calculated as a gross amount (higher of income or expense) of other operating income (OI), other operating expenses (OE) + the higher of fee and commission income (FI) and fee and commission expenses (FE), and, as a result, is uncapped.

This structural overcapitalisation issue was acknowledged by the Basel Committee on Banking Supervision (BCBS) in two prior consultations (2014, 2016) but, without explanation, was not adopted in the final standard. The Consultation's gross amount calculation and uncapped amount of services component operational risk capital disproportionately impacts banks predominantly engaged in fee-based activities. Many of these activities have observably lower historical operational losses than non-fee-based activities. Further, the proposed services component calculation does not differentiate between various fee-based activities, among which there are apparent differences in operational loss rates.

We recommend that the BCBS considers modifying the calculation to reflect the 2016 BCBS consultation. As a result, "high fee banks" (banks with a share of fees greater than 50% of their unadjusted Business Indicator) would account for only 10% of fees greater than 50% of the unadjusted Business Indicator, with net fee income as a floor.

Alternatively, we recommend capping the services component as a percentage of the unadjusted business indicator. This would be consistent with the 2.25% ILDC cap noted above, and it would reduce the disproportionate impact to banks predominantly engaged in fee-revenue based activities.

Question 3: What are your views with regards to the proposal for the Financial component? To which extent are you carrying out operations or making accounting choices as referred to under paragraph 2, point a) of Article 9 of this draft RTS? Are you carrying out operations or making accounting choices, other than those specified under paragraph 2, point a) of Article 9 of this draft RTS, that could justify the use of the PBA? Please explain and provide arguments for your answer.

According to Article 314.4 of the CRR, the trading book component (TC) of the financial component (FC) should be "defined as appropriate either in accordance with accounting standards or, in accordance with Part three, Title I, Chapter 3" (i.e., the prudential boundary criteria). This requirement is also explicit in the mandate of Article 314.6 which requires that EBA develops the list of typical sub-items of the business indicator by "taking into account international regulatory standards and, where appropriate, the prudential boundary defined in Part three, Title I, Chapter 3".

The draft RTS in the consultation does indeed provide the two required approaches to calculate the financial component in the proposed accounting approach (AA) and prudential boundary approach (PBA). There are, however, several issues with the requirements envisaged by EBA.

First and foremost, the AA has been made the default approach while the PBA can only be used by way of derogation after meeting some conditions. This requirement goes beyond that of the CRR which does not favour one approach over another but, rather, requires that the PBA be available for institutions to whom it is appropriate. An institution should therefore be able to choose the PBA on a permanent basis if it considers it to be more appropriate. It should be noted that the CRR already imposes very strict requirements for the management of the trading book including for the inclusion of positions (Articles 102, 103 and 104), and equally strict rules to reclassify a trading book position (Article 104a), which contributes to the robustness of the PBA approach. However, to avoid continuous changes from one approach to another, it appears reasonable that when an institution has made the decision to apply the PBA, it would only be permitted to revert to the AA (or the other way round) if such change is triggered by material evolutions of its activity, environment or risk management (for example a change of business model) .

Second, in the approach proposed in the RTS, the application of the PBA is conditional to several criteria including the presence of certain operations or accounting choices that result in an "unwarranted increase" of the FC when using the AA. Once again, this would limit the usage of PBA while CRR does not favour one

approach over another nor intend to limit the usage of PBA. Furthermore, an unwarranted increase in the TC's P&L over a certain period can be volatile by definition as it can be impacted by several market factors. An institution can therefore experience an unwarranted increase in a given reporting period and not experience any in a following reporting period while having similar operations and accounting choices. The application of the PBA should, therefore, not be based on an unwarranted P&L increase in the TC nor be subject to any limitation. In any case, the potentiality of such increase demonstrated ex ante shall be sufficient and would avoid volatility.

The introduction of an automatic reversal to the accounting approach (that could be considered as a simplified approach) is inappropriate, because in times of crisis, this reversal might lead to an undue decrease of the BI compare to the prudential boundary approach . It will be more appropriate and justified to only include consistency over time on the approach chosen and requiring prior permission before switching. The industry suggests the following changes to that article 14:
"Article 14 Reversal to the accounting approach:

> ***An institution shall use, consistently over time, the accounting approach or the prudential boundary approach. An institution shall notify the competent authority before switching from one approach to the other."***

Scope of entities applying the prudential boundary approach (PBA)

According to the draft RTS on the components of the Business Indicator, the prudential boundary approach to be permitted shall apply to all entities of a same consolidation group.
However, for entities with little or no market activities or when accounting portfolios are in line with prudential portfolios, it would be operationally difficult to apply the prudential boundary approach due to the documentation to be provided and due to the policies and procedures constraints compared to the benefits expected, while using FINREP would be easier.
Therefore, we believe that institutions should be allowed to choose the appropriate approach in those specific cases, provided that the approach used is consistent from one financial year to the next and that the approach would change only under specific or rare circumstances.
We ask to introduce proportionality principles in that requirement permitting to ensure consistent application avoiding cherry picking at the group level without undue implementation costs. In fact, some entities in the prudential Group may have differences between their accounting and prudential perimeters but with limited unwarranted increase of the financial component. For those entities the cost of implementation largely overseed the benefit. For example, this principle already exists for market risk calculation in CRR 3 (combination of approaches and simplified approach as accounting approach).

Finally, the notification process seems very cumbersome, especially as all the requirements (points (a) to (h) of Article 13.2 of the RTS) should be reviewed annually. All these requirements should only be required for the initial notification of the intention to use the PBA and the annual review should be limited to the independent review on the fulfilment of the conditions to use the PBA (point (h) of Article 13.2 of the RTS).

Question 4: What are your views with regards to the proposal for the specification of the items to be excluded from the BI? Please explain and provide arguments for your answer.

As a general remark, we note that Chapter 4 (Article 16) is titled "Elements to be excluded from the business indicator". However, the chapter lists what's *not* excluded, which can be quite confusing to apply. It would be more helpful to have an actual list of exclusions – else, it's difficult to be sure of completeness of exclusions.

In this sense, income and expenses from insurance or reinsurance business are to be excluded from the calculation of the business indicator under CRR3. However, Art.16 of the RTS specifies that where these are "resulting from the distribution of insurance or reinsurance products or services" they shall not be excluded. Given that EU credit institutions are not able to act as insurance providers[1], the clarification included in recital 12 and Art.16.1.a of the RTS would invalidate the CRR3 exclusion from the BI of income and expenses from insurance or reinsurance business. This is as no amounts comply with such characteristics (i.e. income or expenses from the insurance business in a credit institution not resulting from the distribution of insurance products). Therefore, eliminating this clarification introduced by the RTS would invalidate Art.314.7.a clause in the CRR. Additionally, we would like to note that income and expenses coming from the distribution of insurance products are already subject to operational risk capital requirements under Solvency II, so not excluding them from the business indicator would lead to a capital double counting situation. Finally, income and expenses from the distribution of insurance products are exempted from the BI in the UK regulation issued by the PRA.

Therefore, the proposal of Art.16.1.a of the RTS for the specification of the items to be excluded from the BI should be modified as follows:

"*The exclusions referred to in Article 314(5) Regulation (EU) No 575/2013 shall be applied as follows*:

a) for the purposes of Article 314(5) point (a) of that Regulation, income and expenses resulting from the distribution of insurance or reinsurance products or services manufactured or provided by an insurance company falling under Directive (EU) 138/2009 (Solvency II Directive) scope or under third country regulations that are considered equivalent under articles 172, 227 and 260 of such Directive, shall be excluded from the calculation of the business indicator".

AFME and its members believe that realised profits and losses from the sale of non-trading book items and income from extraordinary or irregular items should be excluded from the Business Indicator. We believe that these items do not reflect the institutions' "business as usual" and are not reflective of their operational risk profile and should be excluded from the BI calculation. For instance, the sale of an ALCO portfolio (which, in principle, is expected to provide income over a certain period of time).

We would like to highlight that there seems to be a discrepancy between Article 314.5 of CRR3, which lists the elements that should be excluded from the calculation of the Business Indicator, and some of the items being requested in Template 16.03.

This is as while the Article 314.5 states that "institutions shall not use any of the following elements in the calculation of their Business Indicator":

(a) "Administrative expenses, including staff expenses, outsourcing fees paid for the supply of non-financial services, and other administrative expenses"

(f) "depreciation of tangible assets and amortisation of intangible assets**, except the depreciation related to operating lease assets,** which shall be included in financial and operating lease expenses";

… the template 16.03 is not consistent with this Article and requests the following fields:

- 0020 "Administrative expenses to operational risk events"
- 0030 "Depreciation due to operational risk events"

It would be necessary to amend fields of Template 16.03 by:

- Removing 0020 to comply with the exclusion of Administrative expenses

[1] Art.4.1.1 CRR excludes insurance undertakings from the definition of credit institution.

- Amending the content of 0030 so that it corresponds to "Depreciation related to operating lease assets".

Question 5: What are your views with regards to the proposed mapping of the BI items to the FINREP cells? Please explain and provide arguments for your answer.

With regards to the exchange rate, the calculations of operational risk requirements are based on the average of the values at the end of the last three financial years. Taking also into account that operational risk losses will materialise in the currency in which the company operates, we consider that the exchange rates to be applied in the case of subsidiaries with a currency other than the € for the purposes of calculating own funds requirements for operational risk should be the exchange rate applicable at each reporting date.
Otherwise, should FINREP exchange rates were used, capital requirements would be:

- Outdated: Up to a 3-year gap since historic FX rates would be used.
- Inconsistent with credit & market risk frameworks, which are calculated with up-to-date FX rates.

Separately, we note that Interest income "(k) profits from leased assets including gains from lease modifications" F45.03_r0040_c0010 (only from leased assets) versus other operating income "(b) income from other income" F45.03_r0040_c0010 (in total) results in double count. This should be rectified in the reporting template.

Question 6: What are your views with regards to consider the financial statements used for the final valuation as the only reference for the acquisition of activities under the baseline approach (i.e. full historical data)? Please explain and provide arguments for your answer.

No response.

Question 7: What are your views with regards to the proposed three alternative calculation approaches instead of a unique alternative approach to be defined? Please explain and provide arguments for your answer.

Retrospective consideration of business results and balance sheet values of the years prior to initial consolidation is not recommended from a technical point of view and cannot be correctly represented ex post. By acquiring a company, new and profit-relevant synergy effects arise at the administrative level and in the determination of results through technical processes on the part of the new parent group company. In particular, the elimination of intermediate results (intra-group transactions) and financial effects through balance sheet and equity consolidation are significantly affected. The inclusion of historical values before initial consolidation therefore constitutes an incorrect financial result. In addition, the acquisition of a company also entails an adjusted strategic orientation for the acquired company, both in terms of the profit-making strategy, the product range and the risk tolerance. It is therefore recommended that the company results of the newly consolidated subsidiary be taken into account only from the time of initial consolidation. This corresponds to tax and financial reporting. Then the presentation of results corresponds to new business or the results of a new business line, which reflects the real perspective of the parent group company.

Question 8: What are your views with regards to not providing any alternative method but adjustment to the effective perimeter of the disposal? Please explain and provide arguments for your answer.

No response.

Question 9: What are your views with regards to the inclusion of a threshold? Please explain and provide arguments for your answer, as well, if applicable, further evidence on situations where BI adjustments as set out under articles 1 and 2 would not be feasible or deemed excessively cumbersome and identify potential consequences on the dynamics of the European financial markets.

The reason for the EBA to not provide a definition of materiality thresholds is not clear. It would be beneficial to define both relative and absolute thresholds to guide market participants on materiality. We suggest this should be considered in parallel with potential situations which are "not feasible or deemed excessively cumbersome", which is requested in the CP.
In particular, we are in favor of including a threshold for mergers and acquisitions, as this would avoid high operational costs for acquired or merged entities that have no significant impact on the Business Indicator of the group.

We suggest the Net Operating Income of the group as defined in FINREP reporting as the relevant basis for calculation. The materiality threshold would be defined as a percentage of the Net Operating Income of the group and should be calibrated to 2% of NOI. Below the threshold, no manual retreatment of the BI is done. Entities acquired would only impact the BI through future FinRep calculations.

Question 10: What are your views with regards to the basis for the calculation of the threshold? Please explain and provide arguments for your answer.

While we agree that using the operational risk capital requirements as the basis for the calculation of the threshold, it would indeed entail going through the full calculation of the adjustments to the business indicator for every operation. We therefore propose using the net operating income as a basis for the calculation of the threshold. This basis ensures that non-material operations with insignificant impact on the NOI are not making the process of business indicator adjustment unduly cumbersome.

Question 11: What are your views with regards to the level you consider would be appropriate for the threshold? Please explain and provide arguments for your answer.

The materiality threshold should apply at the level where capital requirements for operational risk are being calculated and should represent 2% of the related NOI.