ASSOCIAZIONE BANCARIA ITALIANA

Position Paper of the Italian banking industry on "Sound Practices for the Management and Supervision of Operational Risk"

March 2002

A) General comments

Italian banks consider that in general the principles set forth in the first part of "Sound Practices for the Management and Supervision of Operational Risk" are reasonable, as they are basically the same as those already issued with respect to market risk.

As for the actual transposition of the principles into the reality of banking, the Italian banking community fully endorses the position expressed by the Committee at the outset of the document, namely that "The formality and sophistication of the operational risk management process should be commensurate with the risk incurred by the bank".

We appreciate the Committee's action in disseminating information and documents to serve as reference both for the nascent functions of operational risk management and for the future development of operational risk management activities already under way.

However, this contribution needs to be read in the context of other papers that the Committee has recently released on procedures for the measurement and management of operational risk. ***In particular, there should be better clarification of the interrelation between the Sound Practices document, the Qualifying Criteria for the various methods envisaged for determining capital charges, and the criteria laid down for Pillar II.***

It is emphasized, in this regard, that a good number of the principles (such as nos. 5 and 6) are hard to apply to banks that decide to use the Basic method, so that the ***reference to Sound Practices needs to be modified*** (indicating only some of the ten principles) or deleted from paragraph 561 of the "New Basel Capital Accord" (January 2001) and from the paragraph on the Basic Indicator Approach in "Working Paper on the Regulatory Treatment of Operational Risk", September 2001.

A similar observation is made with reference to the relevance of some of the principles, and the terms contained therein, in the case of application of the Standardized Approach. For example, the term "measurement", in its acceptation of "calculation of capital charge" (see Working Paper of

September 2001, p. 12), appears to be consistent with the requirements of the SA method. However, if used to mean "measuring operational risk [which] requires … estimating the probability" of an operational loss (see Sound Practices §27) it is clearly inappropriate in the SA method framework.

This suggests the need to differentiate the principles according to the method used for calculating capital charge that is used.

A first general comment concerns the differing thoroughness of consideration of methodological as against organizational issues. The former are treated more amply, while the only references to organizational issues in the first part of the Sound Practices paper, except for principles 1 and 2, are in point 17 (the independence of internal auditing from the management of operational risk) and point 19 ("staff responsible for monitoring and enforcing the institution's risk strategy have authority independent from the business units they oversee").

The suggestion, then, without prejudice to the complete organizational independence of every bank or to the need to bear the size of the bank in mind, is to better specify some of the organizational principles governing the function of coordinating the measurement and management of operational risk. For example, some ideas can be drawn from paragraphs 49 and 50 in the second part of the Sound Practices.[1] It could also be useful to better identify the frontiers between that function, the individual business units and the other corporate functions.

Finally, let us offer an observation on the Committee's intended contribution in the second part of the document, which was highly appreciated by the Italian banking community for its richness of reflection. Consisting essentially of a list of the best current practices, it needs to be clarified whether these are intended as ***suggestions*** for implementation by single banks – inasmuch as the regulators deem them to be in keeping with the principles set out in the first part – or whether they are a mere overview of the state of the art. In either case, we suggest creating, using this second part as a basis, ***an additional, self-standing paper***, to be updated periodically, reflecting developments in this field and signalling progress in the industry.

If this line is accepted, we should like to point out that also in the first part of the document there are some paragraphs that, if they are intended as examples, should be placed in the second part (e.g. point 26).

B) Proposed modifications and other contributions

With reference to **principle 1**[2], the Italian banking industry asks that the sentence "The board of directors should be aware of the major aspects of the bank's operational risks as a distinct and controllable risk category…. " be replaced by "The board of directors should be aware of the major aspects of the bank's operational risks as *a distinct risk category whose effects are controllable*…". Such a change reflects the fact that the concept of controllability is more properly applied to the effects of the event than to the risk-generating event itself.

[1] §49. "…..leading banks have, or are in the process of putting in place, clearly defined organisational structures for managing operational risk that are comparable with existing structures for market and credit risk". §50. "Many banks have established an independent operational risk management function at the corporate level that has a direct reporting line to senior management…..".

[2] We ask confirmation that the terms "board of directors" and "senior management" (in Principle 1 and elsewhere) correspond to the Italian "Consiglio di Amministrazione" e "Alta Direzione".

In point 24 of **Principle 3** we suggest amending the sentence “In order to assess accurately risk exposures against risk tolerances stated in the board’s strategy and adherence to internal policies, processes and procedures, senior management should receive regular reports from both business units and the internal audit function” to read “In order to assess accurately risk exposures against risk tolerances stated in the board’s strategy and adherence to internal policies, processes and procedures, senior management should receive regular ***reports from the independent operational risk management function and/or from the business units*** and the internal audit function”. In fact, the current wording would appear to exclude a direct reporting line to top management for the central operational risk management function, where one is in place.

For **Principle 4**, we consider that it needs to be reworded to bring out the **connection between the terms “new” and “adequate”**. It is proposed, therefore, to amend the final part of the principle to read “the related operational risk be subjected to valuation procedures adequate to the nature and the scope of the innovation introduced.”

Principle 5 might well include the procedure for including service level agreements in outsourcing contracts; in some cases such agreements are both operationally and legally viable instruments for mitigating operational losses in connection with the outsourced activities.

Paragraph 36 mentions reputational risks in connection with outsourcing. This raises the necessity of clarifying the relationship between the definition of operational risks for purposes of capital adequacy and their definition for the implementation of Sound Practices.

As a contribution on the definitional aspects of operational risk mentioned in point 56 in the second part, the Italian banks are pleased to submit the substance of the agreement under their DIPO interbank data pooling project, which is about to be launched. The key element in DIPO (the “domain”) is the individual loss event that causes ***effective operational losses***. This term refers to objective, measurable impact on the profit-and-loss account, regardless of how the events are entered and of the accounting heads. It is agreed that the value to be recorded is the cost required to resolve the event net of any costs for “improvement of controls”, for preventive actions and for investments in new systems, but gross of the amounts recovered (insurance or other).

C) General considerations on operational risk

We take this occasion to submit a set of observations, some of them already presented in other circumstances, on aspects of operational risk not explicitly treated in the Sound Practices doucment but nevertheless important to the current consultation.

Caps

It is necessary to set caps both for the Basic and for the Standardized approach, in order to attenuate the unjustified effects of the linear relation between gross income and the capital charge.

Definition of business lines

ABI’s interbank working group on operational risk repeatedly noted the difficulty of rightly interpretating the business lines identified by regulators in a national context characterized by commercial banks. Objectively, it is a complex matter to agree, at international level, on a definition of business lines solely through an exhaustive and not overlapping list of activities such as the Committee proposes. We thus suggest supplementing this information with a few guidelines or criteria that can be used in dubious cases both as regards the use of risk indicators and with reference to correct reporting of operational losses incurred in the various lines.

Further, we can report the interest of Italian banks in a new ordering of business lines that would merge retail and commercial lines business. Also, the working group noted the usefulness of introducing an additional business line, the “corporate center”, composed of infrastructural support units, to which to attribute all losses deriving from centralized activities for which no particular business line is directly responsible.

Risk mitigation

Considering that:

- it has been decided (in the September 2001 working paper) to switch from an average 20% to 12% incidence on the minimum capital requirement, in view among other things of the practice of risk transfer via insurance, both innovative and traditional;
- all three methods benefit from this decision (AMA via the floor, the others directly)

we fail to see why the additional possibility of reducing the capital charge through an explicit statement and verification of the risk component transferred via insurance products (including standard ones) should be allowed only in the AMA.

The motivation, which is not made explicit in the paper, that only the banks using the advanced measurement approach have the capability of determining that the transfer price is reasonable, is not warranted in the case of standard insurance products on whose pricing the individual bank has no effect, precisely because it is not personalized.

Accordingly, as in our previous position paper, we ask the ***recognition of insurance cover***, as a partial reduction of capital charges for operational risk, at least for the most commonly insurable risks in Europe (fraud, theft, robbery, etc.), and ***for all three approaches***.

As a method of calculating the extent of the reduction, we propose taking account of such elements as ***maximum insurable amounts*** and ***deductibles***.

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