Position Paper on CP 21 - CEBS's Compendium of Supplementary Guidelines on implementation issues of operational risk

March 2009

POSITION PAPER

Introduction and General Remarks

The Italian banking industry appreciates the CEBS initiative to set out its views on the implementations issues of operational risk.

The Italian Banking Association (ABI) and the DIPO Consortium (Italian Operational Risk Losses Database), in order to prepare the Italian banking industry's position on the CEBS consultation paper (CP21), have collected the various points of view of its members and gathered a series of proposals concerning the aspects addressed.

Based on the comments received and on the activity of interbank working groups, ABI and DIPO drafted the attached position paper, transmitted to the CEBS and to the Italian Supervisory Authorities.

ABI and DIPO are in favour of all initiatives that will contribute to achieving further market integration and supervisory convergence and that reduce the supervisory burden of cross-border banks. Therefore, they welcome the opportunity to respond to the CEBS consultation.

Nevertheless, ABI and DIPO believe that some improvements and adjustments to the proposed text are necessary. As requested, we set out hereunder our drafting proposals to some provisions.

DIPO has 35 members (banking groups or stand alone banks) and around 193 legal entities belonging to DIPO's members send data to the Consortium. These 193 entities represent 42% of the Italian banking system in terms of number and 80% in terms of Operative Costs (an indicated from the balance sheet).

Specific Remarks

LEVEL OF APPLICATION

"Guidelines on the scope of operational risk and operational risk loss"

1. Introduction

With respect to our contribution to the issues addressed by CEBS (Scope of operational risk loss and event triggered by legal settlements), we would like to share and submit to your attention DIPO's Effective Loss Gross Definition (attached 1), the document addressing losses associated with legal risk (attached 2) and the document about the treatment of cross-border losses with Credit Risk (attached 3).

In the CP 21 wording, it would have been useful to distinguish between the Data Set for Minimum Capital Requirement Calculation for Operational Risk and the wider Database for operational risk management purposes. As an example, Pars. 21 and 23 (first bullets) would have been more understandable.

2. Objectives and content

Paragraph 12: Operational risk versus reputational risk does not appear to be an issue because it is explicitly excluded from the operational risk definition.

3.1 "Operational risk versus market risk"

Paragraph 17: it is not clear how to manage "the loss due to adverse market conditions" within the scope of operational risk loss. It would indeed at this stage not be practicable to single out the adverse market condition-part of the loss for the four types of events listed in paragraph 16. This part should be removed or more concrete guidance provided.

It must be clearly stated that the amount of the loss is fair and only related to the event occurred (the failure, the error, the fraud…), when it is discovered. If the firm decides not to close the position immediately, this is not an operational risk, but a market or business one. This item must be stressed, in order to allow firms the freedom to choose the best solution.

Table *'Examples to be included in the scope of operational risk'* (p. 9):

Fifth bullet under "Due to operational errors" - It should be better defined what kind of losses are included as "technical unavailability of access to the market (e.g. system down)". For instance, losses which result from the impossibility to close existing contracts for financial products (e.g. derivatives) should be included in this category. However, those events which refer to mere intentions to operate during a system down period should not.

3.2 "Operational risk versus strategic risk"

Table 'Examples to be included in the scope of operational risk' (pp. 10-11):

1. ABI and DIPO believe that "Compensation paid to employees" (third bullet) should not be an event to be included in the scope of operational risk. Some types of compensation are not related to operational risk such as compensation linked to early retirement incentives and additional compensation in the case of an employee's resignation. These types of compensation are a firm's own decision and are not related to avoiding losses due to legal risk.

   Therefore, ABI considers that the example should be amended as follows:

   "~~Compensation paid to employees and~~ refunds to customers before they can lodge a complaint but, for example, after the firm has already been required to refund other customers for the same event;"

2. In this paragraph, the notion is introduced of considering customer refunds, as operational risks, for events with respect to which the firm has already been required to pay compensation prior to the customer filing a complaint.

   In this way, the autonomous decision making of the firm is not recognized, which may deem it appropriate to compensate the customer so as to avoid losing the customer directly or acquiring a bad reputation, that is for purely commercial purposes.

   We suggest eliminating the phrase "before they can lodge a complaint".

The events (and the related losses) described below should be included in the "scope of strategic risk"

ABI and DIPO believe that the guideline should clarify how to handle customer complaints without breaching any rules, regulations or ethical conduct. The following modification is suggested:

"Losses incurred by the firm as a result of inappropriate strategic/senior management decisions or business choices which do not breach any rules, regulations, or ethical conduct, **and which are not triggered by legal risk".**

Strategic risk would consequently include customer refunds but only when the related events would not be connected to any breach of rules, regulations, or ethical conduct. This is moreover consistent with what is already stated in the previous paragraph 18 point A.

The clarification of what represents strategic risk is helpful particularly in the context of conducting top down Risk Assessments with senior management. Apart from what is defined in Pillar2, splitting strategic risk into two subcategories has proved to be concretely useful[1]:

- business or commercial risk;
- "pure" strategic risk ".

By business risk, we mean by fluctuations of profits/margins compared to the expected data, which is not associated to other risk factors (for example, interest rates), but to the volatility of volumes or changes in the tastes of clientele; such risk can be measured and refers to an operational context based on an unvaried strategy.

The second category, "pure" strategic risk, is associated with phenomena of a significant business discontinuity from the main strategic choices initially adopted. For example, entry into new markets or the adoption of operational choices extremely different from the ones pursued so far, are considered 'pure' strategic risk.

Table *'Examples to be included in the scope of strategic risk'* (p. 11)

"Losses relating to decisions **intentionally** made by the competent decision-making body which are not compatible with the firm's risk tolerance level and deviate from its core business activities" (second bullet point) are a strategic risk to the extent that those decisions are made by the competent decision-makers. However, should the loss be related to a breach of **formalised** procedure, then it should be included in the scope of operational risk and excluded from strategic risk."

4. The scope of "operational risk loss"

Paragraphs 20, 21 and 22: "Pending losses" should be excluded from the scope of operational risk. Indeed the monitoring of the huge amount of transitory and/or suspense accounts in order to detect operational risk losses is not sustainable from an operational risk management perspective.

Even the mere notion of only monitoring/considering those high impact pending losses could create several problems. For instance, what if a scenario is included in the scope of operational risk losses and then the related transitory item turns into a concrete loss in the P&L? Should the scenario be eliminated from the dataset of CaR calculation in order to avoid double counting?

Furthermore, problems of stability of AMA estimation may occur due to natural unavoidable fluctuations in pending losses and internal inconsistency can occur in quantifying the scenarios since transitory and suspense accounts are by definition losses with uncertain amounts and process owners (for example accounting and

[1] From the White Paper on Pillar 2 from ABI and PwC, Bancaria Editrice 2008

legal) do not have the elements to provide an estimation (otherwise they would have booked related items in the P&L as provisions and not as suspense accounts). As a consequence, it would be very difficult to receive impact quantification.

Moreover, well-defined criteria are necessary to select which pending losses should be included in the scope of operational risk loss via scenario; what does "expected to have a high impact" (paragraph 22) mean in concrete terms?

Paragraph 23, second bullet: the part where the timing impact is divided into temporary and permanent distortions is unclear. ABI and DIPO believe that all the "timing impacts" should be excluded from the CaR calculation (not only those which cause a clear temporary distortion of P&L), because they rectify accounting positions regarding previous periods but they are not proper operational risk losses.

LEVEL OF APPLICATION: AMA FIRMS

“Guidelines on the scope allocation of the AMA capital”

3. Assessments of allocation mechanism

Paragraph 10: This may result in some supervisors imposing additional requirements on subsidiaries. Here the question is whether this is done via Pillar I or Pillar II. It should be Pillar II, without affecting the group wide model.

4. Home-host issues regarding allocation mechanism

Paragraph 15, in combination with paragraphs 13 and 14: A change in the capital allocation mechanism should be considered as a model change. Even if a new application is not necessary, a significant change to the allocation methodology should be based on a joint decision”. The exact procedure (and necessity) to obtain approval for a new allocation mechanism is not clear to us, especially the procedure to arrive at "a joint decision" by home and host regulators.

DIPO definition for the field “Gross actual Total Loss” in the record related to each single operational risk event

By actual losses we refer to negative income flows:
• with an amount equal to at least €5,000 (excluding the records of updating, adjustments or deletion).
• Characterized by the certainty of the quantification of the amount as reported in the profit and loss account (including specific provisions and excluding generic loss provisions for which the bank is not able to trace back certain and specific events to ‘portion’ of these provisions, cf. question 57 of Modules F).
Hence, the reference criterion is the effective impact on the profit and loss account (including the setting up of provisions), but the record of the loss might not match the gross actual loss. For example, suppose that a robbery has taken place in a given bank: this fact caused a loss of 100 with an indemnity from the insurance company of 90, but the amount of the robbery is recorded only with regard to the amount of the excess clause, namely 10. However, the loss to be reported shall be 100.
• Attributable to the event, either directly or through management/departmental observations.
Direct *attribution* applies both to the loss and to any potential expenses – invoiced by third parties – or related to the settlement of the issue.
• Not due to cost compensations or badly estimated operational profits.
Therefore an example of a negative economic flow to be excluded would be those relating to the delayed payment of a part of the salaries erroneously computed in the previous month, given that it is a case of cost compensations, while any potential accrued interests on these amounts due to the employees shall be reported.
Shall EVs simultaneously entail positive and negative economic flows, only the negative part is to be indicated (not net of profits), whereas the positive one is to be reported under the heading other income (cf. field 21 record track DIPO output flows).
• Not due to the introduction of retroactive regulations.
The value to be registered is the necessary cost for the resolution of the loss event net of the costs sustained for ‘improvement of controls’, precautionary actions and investments in new systems, but gross of the amounts recovered by insurances, that is inter-group recovered amounts.
In case of amortizable goods, regardless of any substitution of the goods, the Gross Actual Loss is defined by its expected value on the date of the loss occurrence (this can be deduced by the insurance company’s appraisals and/or by other technical appraisals) or alternatively, lacking the above by taking replacement costs of goods having similar characteristics.
The data to be indicated shall be a ‘stock’ and not a ‘flow’ measure, thus the cumulative value of the losses incurred shall be reported, even on the updating and adjustment phases of the records.
The amount shall be valued in Euro without the indication of the decimals.
This field will be included in the FEE and FEG cash flow returns.

Clarifications on the definition of legal risk

As defined by B2, **all** court actions where the subject is **defendant** are classified amongst the elements of legal risk in addition to ones aimed at collecting incurred **operational losses** where the subject is the **plaintiff**.

Legal proceedings initiated by the bank for debt collection are not covered in the following analysis.

General Criteria.

- Survey on the first Gross Actual Loss flow (for example, initial legal expenses or initial provision).
- The loss forecast shall be reported to DIPO only when it generates the need for a provision according to accounting criteria. The value communicated by the legal department shall be recorded as a provision amount, before its discounting for IAS purposes.
- Shall the provisions flag be set on 'YES', this will mean that there is a provision **element**.
- The event shall remain open until the definitive verdict. Shall the event be intermediately closed for internal managerial causes, it is necessary to open the same event again and not to report a new one.
- By legal costs we mean only the external ones.

Analysis by typology

Court actions where the bank is defendant (bank summoned before Court)

A) Unfavourable verdict against the bank or out of court settlement
The amount of the Gross Actual Loss will include the interests that the bank shall pay, the amount for the compensation of losses, net of the sum of original dues, and external legal expenses.
Initial ET that is identified on the basis of the subject matter of the action (for example, shall a supplier initiate a legal action against the bank, the ET is 07.06)

B) Favourable verdict to the bank
The amount of the Gross Actual Loss will include **only** external legal expenses.
Initial ET that is identified on the basis of the subject matter of the action
N.B. In case of inner legal expenses, the value of the Gross Actual Loss shall be equal to 0 and therefore the event would not be reported to DIPO.

C) Following the summons, the case might not be settled either by a favourable or an unfavourable verdict for the bank, but by an *agreement* and *transaction between the parties with a disbursement from the bank*; in this event, two sub-cases are to be taken into consideration:

- If the parties reach an agreement only for business purposes, without any mistake made by the bank itself, this case is not considered an operational loss
- When, on the other hand, the bank acknowledges an internal error, this case is considered an operational loss. The amount of the Gross Actual Loss, as in the case of legal action made against the bank, includes interests (legal/on arrears), the amounts

for loss refund, net of the amount of the original dues, in addition to external legal costs.

Court actions where the bank is plaintiff

Only those actions initiated to recover the incurred operational losses

- Should the bank win the case, compensation is to be recorded as other income
- Legal costs shall never be considered an increase of Gross Actual Loss or a curtailment of the possible collections
- The ET is identified on the basis of the subject-matter of the legal case (for example, shall a fraud be perpetrated by an employee, the ET is the 01.02)

The asymmetric treatment of the legal costs is justified by the fact that legal action as a plaintiff are the result of a choice by the bank in terms of mitigation strategy.

Treatment of cross-border losses with Credit Risk

Regarding the **cross-border** operational losses **with Credit Risk**, the Provisions regulating Structural Surveillance provide that (Title II, Chapter 5, Part Three, Section III, Paragraph 2.1):

*"Cross-border operational losses with credit risks are **not** included in the dataset for the computation of the operational risks when they are used on the computational process of the capital requirement on credit risks."*
However, the bank provides to

- *register these risks within the internal bases of operational risks;*
- *apply the consistent preventive and mitigation measures of the relevant risk profile.*

...
"The cautionary treatment of cross-border risks shall ensure the inclusion of every loss within a risk category and shall not result in improper reductions of the aggregate capital requirements."

Hence, for the DIPO purposes, only those cross-border losses with credit risk shall be reported, and which are recorded by the single DIPO Partner in the dataset for the computation of the operational risk.

Regarding the strategic risk, the workgroup opted for a clear distinction between two subcategories:

· entrepreneurial or business risk;
· 'pure' strategic risk.

By business risk, we mean by fluctuations of profits/margins compared to the expected data, which is not associated to other risk factors (for example, interest rates), but by the volatility of volumes or alterations in the tastes of clientele; such risk can be measured and refers to an operational context based on an unvaried strategy.
The second category, that is 'pure' strategic risk, is associated with phenomena with a strong business discontinuity from the main strategic choices initially adopted. For example, entrance into new markets or the adoption of operational choices extremely different from the ones pursued so far, are considered 'pure' strategic risk.