Italian banking system Position Paper in response to CEBS consultation paper: CP 10 “Guidelines on the implementation, validation and assessment of Advanced Measurement (AMA) and Internal Ratings Based (IRB) Approaches

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Introduction

The Italian banking industry appreciates the CEBS initiative. In carrying out its task of strengthening cooperation and promoting European convergence it is taken on the burden of drafting a document laying down the principles for the process of validation and implementation of internal methods of measurement of credit and operational risks in banking.

The Italian Banking Association (ABI), in order to produce an banking industry position on the CEBS consultation paper "Guidelines on the implementation, validation and assessment of Advanced Measurement (AMA) and Internal Ratings Based (IRB) Approaches", has collected the various points of view of its member banks and gathered a series of proposals concerning the aspects treated.

Based on the comments received and on the activity of an *ad hoc* interbank working group, ABI has drafted the attached position paper, transmitted to the CEBS and to the Italian supervisory authorities.

General observations

The guidelines proposed by the CEBS are highly detailed in some parts, while in others more explicit explanation of some concepts would be helpful.
Examples given are a helpful improvement by comparison with the text of the CRD also because they support a convergent interpretation by different regulators (level playing field). We recommend, however, that they always be considered as such and not be allowed to limit the solutions that the banks themselves may devise.

It would be better to enclose the text taken directly from the CRD in quotation marks, eliminating paraphrasing that could confuse the reader.

Comments on individual paragraphs

Paragraph 21: In laying down the principle of proportionality, in our view it has not been made explicit enough which aspects connected with the nature, size, risk and complexity of the institutions are being referred to.

Paragraphs 50 - 51: It would be helpful to refer to paragraphs 333 ff., which specify in detail the nature of the qualitative and quantitative assessments, where are only mentioned here.

Paragraphs 62 - 64: We think the instructions on self-assessment are too restrictive; as self-assessment is, by nature, internal to the bank, we do not think it appropriate for the guidelines to specify which of the bank's bodies should perform it.

Paragraphs 98 ff.: The subsequent introduction of more complex methods is allowed, via approval of the implementation plan.
The minimum level of cover of a rated portfolio for admission to the implementation plan still has to be set.
For some portfolios, which are to be defined as non-material business, the permanent use of the Standard Approach is allowed.
It is evident that the two concepts -- the roll-out entry threshold and the non-material business threshold -- are substantially interdependent.
First, it is important to clarify what is meant by non-material business; second, it would be opportune to a threshold for the overall portfolio, but not counting the volumes for claims treated in permanent partial use, share exposures, securitizations and assets not strictly of a credit nature, plus a number of thresholds at different levels for different portfolios (possibly set according to country of residence for cross-country exposures).

Further, we think it is important to lay down guidelines on possible failure to carry out the roll-out plan. It remains clear that violations can be sanctioned with variable intensity depending on how serious they are, but we think it is important for banks to know, even if only in general, the consequences of such violations.

Paragraph 132:
We propose to amend the following sentence in paragraph 132:
"If not all these processes and functions are based solely on ratings and risk parameter estimates used in calculating capital requirements, at least an effective and material part of them *must* be, so that the ratings and risk parameter estimates used in calculating capital requirements have a substantial influence on the institution's decision-making and actions"
as follows:
"If not all these processes and functions are based solely on ratings and risk parameter estimates used in calculating capital requirements, at least an effective and material part of them must be ***or clearly planned to be***, so that the ratings and risk parameter estimates used in calculating capital requirements have **a*n*** influence on the institution's decision-making and actions".
This is because a sort of roll-out for the use test portion should also be allowed.

Paragraph 155: We ask for confirmation that paragraphs 155 and 158 taken together require banking groups to assign each counterparty to a single category, given the limit of €1 million, which is valid both for the level of EU parent institution and for the application of solo requirements.

Paragraph 154: As for the criteria for handling temporary violations, we think a time standard (checking portfolio assignment criteria once a year, say) is preferable to one of tolerance on the exposure, which would have no effect except to raise the threshold (e.g., €1 million + 10%).
It would also be helpful to clarify whether and how the exposure criterion will fit into the rules for the sub-division of gross income according to business line under the Accord for the Standard method of calculating operational risk.

Paragraph 156: We call for deletion of the second bullet point, as it does not form part of banks' *modus operandi* to ask the customer the amount of his exposures to other members of the banking group.

Paragraph 158: Communication by the parent company of the portfolio (corporate or retail) to which a counterparty belongs would not appear to be sufficient to preserve the principle of single rating required for corporate counterparties (regardless, obviously, of whether the subsidiaries are or are not product companies).
In particular, banking groups generally have product companies specializing in leasing. It is well known that the time required to decide and disburse this kind of credit is very brief, and assessments of creditworthiness are based on different (and generally less ample) sources of information than are used in the class loan application.
To comply fully with the New Capital Accord, a product company that has to provide leasing credit (for a car, say), would have to:

- first find out whether the customer is or is not shared with other group companies;
- if the customer is shared, determine whether the customer is corporate or retail in the light of his relations with all the group companies;
- if the customer is in the corporate portfolio, use the rating assigned by the banking group's operator on the principle of single rating (with the further risk that the rating is not up to date and will thus have to be reassigned).

It is obvious that such a procedure is unsuited to the characteristics and timing of this kind of operation (response time of 2 or 3 hours, in any case less than a day). It would thus be better, at least for small amounts (an appropriate threshold of materiality should be agreed with the supervisor) to apply a product rating and avoid the need for the checks and procedure just described.

Paragraph 162: It is not true that a "significant number of exposures" implies that the number is large enough to generate reliable estimates of parameters; see, for example "low default portfolios". This requirement should be dropped.

Paragraph 170: Determination of the SME corporate portfolio within the corporate portfolio is done by a criterion based on sales volume. The "turnover" variable should be replaced by total assets in cases in which sales are not particular significant. We request that allowance be made for the use of models to estimate turnover that can compensate for lack of the actual data.

Paragraph 195: The definition of default implicitly involves some scope for subjective judgement in the traditional concept (the customer's "unlikeliness to pay"). As to the definition of "past due", the use of purely quantitative criteria, such as the threshold of materiality, has shortcomings (what if a loan goes above the materiality threshold for just one day during the 90/180-day observation period?).
The introduction of qualitative criteria, based obviously on objective factors drawn from reports, would thus be highly desirable -- in combination, of course, with a quantitative materiality threshold. For one thing, from the standpoint of operational risk a qualitative criterion could help avoid the erroneous reporting to central credit registers of positions that

are past due solely for technical reasons or for insignificant amounts. In the past such reports have occasioned legal actions, even for very substantial amounts, in which banks have been sentenced to pay damages.

Paragraph 196: Let us highlight the problem of including historical "past due" items for the final calibration of PD. In some situations, if a materiality threshold set at national level is used there are a significant number of positions that return to performing status. We ask whether it is correct to apply the interpretation whereby the bank can use, in calculating its "past due" positions for calibrating PD, a different materiality threshold that factors in an analysis of this "cure rate".

Paragraph 198: As for the concept of economic loss, we would like to see a table of concordance between CRD and IAS to solve definitional problems and those connected with the actualization rate (IAS uses original rate on the transaction, CRD other rates, such as the risk-free rate).

Paragraph 355 ff.: The Italian banking industry considers that the entire section on "internal governance" is over-prescriptive. For if the CEBS guidelines were implemented literally, banks would suffer a reduction in their independent power to determine their internal organization. The paper proposes standards that interfere excessively with the responsibilities both of management and of supervision. In our view, the CEBS should rather lay down guiding principles requiring banks to assess matters which are relevant to their successfully governing credit and operational risk and to assign responsibilities to their governing bodies and senior management.

Paragraph 418: It is necessary to have explicit clarification whether, in the event that a bank or group elects an AMA approach but this approach is not adopted by one of its units or BLs, it is possible to include also the data of the unit/BL in determining the capital requirement under the AMA, even if the unit/BL does not satisfy the requirements for the advanced method.

Paragraph 426:
a) Italian banks call for publication of clear and definitive rules on the definition of "relevant indicator". We consider it excessively costly for such an indicator to be used only for the determination of the TSA/BIA capital requirement. It is held (aligning with the IAS definition) that this indicator should coincide with gross income calculated for the financial statement.
b) Another problem relates to the method for calculating risk on solo basis. In general, for TSA applied at group level banks proceed to determine the opening per BL of the "contribution to the consolidated" of individual entities constituting the group (and within the consolidation perimeter). What is needed, therefore, is to define a methodology such that, in the event of an additional request to calculate a capital requirement on a solo basis, one can start from the opening on the amount of the "contribution to the consolidated" result, supplementing the amounts relative to intragroup items within BLs using a standard methodology. This methodology would be applied only if the bank considers it appropriate; in any case, those banks which do not use the methodology "contribution to the consolidated" will be allowed to opt for the "official annual report" methodology.
c) It would be good to have further indications concerning the calculation of the average indicator over three years. A numerical example would aid in comprehension; in particular, Italian banks would like to see a specification of the criteria for calculation 1) in the case of new acquisitions; and 2) in the case of the sale of companies.

For example, the CP10 could include a table like the following (which has been drafted assuming a scenario of increasing gross income).

1. Acquisition

Year	t-3	t-2	t-1	Acquisition	t		
GI	30	40	50		60		
Average GI over 3 years			40		50		

2. Sale

Year	t-3	t-2	t-1	Sale	t	t+1	t+2
GI	30	40	50		0	0	0
Average GI over 3 years			40		30	16.6	0

In Case 1 it would be useful to take account of the moment in which the acquisition is effected (for instance, if the acquisition is made on the 1st of November it is correct to assign the capital charge to the purchaser only for the last two months of the year; for the first ten months it should remain with the seller).
Still on Case 1, the example proposed here is only applicable where the capital requirement is calculated on a solo basis taking account of public register data. It is evident that an alternative solution must be devised since the amount of the "contribution to consolidated" result is not known for periods previous to *t*.

Combining the two cases set out in the table brings out an obvious asymmetry, in that if the capital requirement is imposed in the case of acquisition (Case 1), there is no analogous treatment in the case of sale (Case 2), because this creates a situation in which two institutions (the buyer and the seller) both pay a capital charge relating to the same entity).
Nevertheless, in awareness of the conservative assumptions of regulators, the case of capital requirements on companies sold has also been inserted in case 2. However, we call for an exemption from this requirement where it can be demonstrated that at the time of the company's sale the total transfer of any and all future operational risks has also been negotiated.

Paragraph 437 (point 2 of the "Principles"): Specify how it is possible to demonstrate that a model is becoming "robust". In fact, one can demonstrate the "static" condition of a model but one cannot make judgement on its "dynamic" condition. Moreover, to maintain today that a model is more robust is tantamount to affirming implicitly that in the past it was less than fully robust, so that the values calculated in the past may not have been fully reliable.

Paragraph 445: While Italian banks agree with the idea of reconciliation between the loss and the accounting databases, they point out that total reconciliation, or a substantive squaring of the two databases, appears impossible. All the more insofar as the two take data using totally different standards and schedules. It is also asked whether the term "material accounting data" is to be understood to mean the number of items entered in the accounts or the amounts.

Paragraph 451: Greater clarity is needed on the inclusion of EL in banking business practices.

Paragraph 455: Scenario analysis is not restricted to providing information on extreme events; the value of scenario analysis lies in its forward-looking point of view.

Paragraph 463: The Italian banking industry thanks CEBS for having essentially accepted ABI's suggested amendment (Amendment 10, below) in the CP10.

Amendment 10
Annex X Part 3 paragraph 27

27. The provider has a minimum claims paying ability rating of A (or equivalent); (a) The insurance policy must have an initial term of no less than one year. For policies with a residual term of less than one year, the credit institution must make appropriate haircuts reflecting the declining residual term of the policy, up to a full 100% haircut for policies with a residual term of 90 days or less. (b) (…);	27. The provider has a minimum claims paying ability rating of A (or equivalent); (a) The insurance policy must have an initial term of no less than one year. For policies with a residual term of less than one year, the credit institution must make appropriate haircuts reflecting the declining residual term of the policy, up to a full 100% haircut for policies with a residual term of 90 days or less. ***The above provision does not apply in the case of policies subjected to an automatic renewal at maturity.*** (b) (….)

Justification

As to the possibility of a lower capital charge by virtue of insurance policies of more than a year's duration, we would like to point out that ***the normal operating practice is to renew operational risk insurance annually, and expiration dates may coincide with a variety of different renewal dates***. Thus on any given observation date for the capital requirement, ***the residual life of a policy may be less than a year***. It therefore seems illogical to pro-rate diminishing the mitigation effect simply because the policy is subject to renewal. We request, consequently, that for policies that are not one-off but stipulated on a continuing basis, the provision in point a) of §27 on policies with less than a year of residual life should not apply.

With a view to the practical possibility of differential treatment, less penalizing for policies "stipulated on a continuing basis", given the present supply of policies, the text needs to be amended as follows:

463 – *ABI VERSION* –"However, this haircut is not required **<u>for policies that are not one-off but stipulated on a continuing basis</u>** with terms and conditions similar to the current terms and conditions, and has a cancellation period on the part of the insurer of no less than **<u>120 days</u>**."

A possible alternative to this wording should in any event solve the two following problems problems banks have pointed out in connection with the current set of insurance policies and practices:

- 463 *"However, this haircut is not required if the contract stipulates that the policy has an automatic renewal option with terms and conditions similar to the current terms and conditions, and has a cancellation period on the part of the insurer of no less than one year"* - The fact is, though, that for major policies insurer will not accept automatic renewal.

- It must be kept in mind that insurance policies do not generally carry renewal options similar in content to that indicated here (this wording would appear to refer to an option that the insuree can exercise and which the insurance company is obliged to execute. As a rule, in the insurance policies found in today's market, only the following concession is made: If notice of cancellation of the contract is not given by one of the parties within 90 days prior to its expiry, it is understood to be tacitly renewed for another year on the same terms. In the same way, we must note that it is not the current practice of insurance companies to allow notice periods longer than 120 to 150 days. Making the “hair cut” question all the more critical is the consideration that in BBB coverage (employee unfaithfulness, robbery, computer crime, etc.) this mechanism of automatic renewal in the absence of cancellation is not operative; rather the policy simply terminates on the contractual expiry date with no obligation on either party to give notice of cancellation.