Italian banking system Position Paper in response to CEBS consultation paper: CP10 Revised “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 revised 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, in particular on paragraph 4 on operational risk. On paragraphs 2 and 3, in fact, we will re-propose some comments we presented during the first consultation.

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

General observations

Given the **high level of details** in some part of the document (particularly in the AMA paragraphs), we have a deep concern that a **check list approach** may be used by regulators or at least by some of them (creating a **level playing field issue**).

The effort of describing some techniques or processes is welcome for a general improvement AMA culture, but publishing these interesting contributions in a CEBS Guide Line Document can not be considered the right choice.

The guidelines could be interpreted as a further level of regulation: this could limiting or replacing a common knowledge developed during other consultation processes. It should be made clear the strength of each recommendation **("nice to have" or "must have"**) both to the banks and to the supervisors.

Regarding the topic of prescriptiveness of the CP10, we continue to support a principles-based approach that provides high-level guidance on key validation and implementation issues. We believe, in fact, that CP10 may inadvertently be interpreted as introducing numerous prescriptive requirements beyond those established in the CRD.

Governance and Control: banks are generally concerned about the excessive level of prescriptiveness present in CP 10 as to the role of senior management in regard to advanced models. Involvement by either the supervisory level or senior management in details as opposed to strategy and oversight of processes may create inefficiency and could even detract from good risk management practices.

Finally, regarding the documentation requirements and self-assessment we would like to underscore that the combination of documentation requirements arising from the "use test" and those related to the obligation of banks to demonstrate to their supervisors that they meet minimum requirements at the outset and on an ongoing basis poses many challenges for banks.
There is therefore a risk in that a "general" request for the documentation contained in Par. 277 and the description of self-assessment contained in Par. 64 could easily devolve to a voluminous, paragraph by paragraph, self-assessment process, unable to differentiate amongst mission-critical elements and less-central aspects.

Comments on individual paragraphs

SECTION 2 – Cooperation procedures, approval and post approval process

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.

SECTION 3 - Supervisor's assessment of the application concerning the minimum requirements of the CRD – Credit Risk

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 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 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 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?).

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).

SECTION 4 - Supervisor's assessment of the application concerning the minimum requirements of the CRD – Operational Risk

Operational Risk is too young to be "rule driven" as opposed to "principle driven". Common work has still to be done among banks, regulators, researchers and professionals and we fear the proposed rigid approach could stifle progress, innovation and accuracy.

As a general comment, there is a very specific model underlying this document, which focuses on the application of LDA and quantitative analysis. In the document other approaches (i.e. scenario analysis) seem to be considered only in order to generate data to supplement historical loss data. The international banking industry has developed other approaches based on scenarios which could be considered at the same level as LDA. The text links the scenario analysis to external and internal loss data in a very strong way, reducing the forward-looking approach that should be the main value of the scenario analysis; internal and external relevant loss data should have a guidance but not binding role starting for the experts opinions.

The major concerns are related to the treatment of correlations with particular with regards to the newly introduced issues of super-additivity and tail correlation.

Coming to the single paragraphs we would point out what follows.

Section on Confidence Level. It seems that mechanism to scale results obtained at lower confidence level could be allowed in the case of scarcity of loss data in the tail. Appreciating this opening, we nevertheless, fear that a specific model (e.g. EVT) would be imposed in determining the scaling ratio becoming in practice a regulatory prescription of the model to be used.

Section on Scenario Analysis. The granularity applied to the scenario generation should be primarily guided by management considerations and by the internal use of results in the risk management process.

Section on Business Environment and Internal Control Factors It is not clear in which way BE & ICFs should be "closely aligned" with the quality of the institution's control and operating environment.

Section on Insurance. We would like to see a more flexible and pragmatic approach by regulators on at least on two issues:

- restrictions in term of minimum rating of the insurer. This is crucial since in many cases insurance are taken with pools of companies some of which could be rated (or even unrated) less than the prescribed level
- treatment of the initial and residual term of the insurance policies.

Given the evolution in this field, both on the banking and insurance side, only a bendy supervisory approach will grant the implementation of this part of the Directive that recognizes insurance policies as a sound operational risk mitigant.

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 453. It seems that the model should be applied consistently across the risk classes. This could pose problems for institutions in which the four key elements of the model are applied at different level of granularity (more detailed the qualitative ones and, for obvious reasons, less granular the quantitative ones).

Paragraph 456c and J. Need to clarify the term "rapidly recovered loss events".
The choice of the period is an important one because it determines whether or not some losses can be treated gross or net in the internal model. For this reason the period should be a choice of the bank even if we agree in principle to flag in the calculation dataset the "rapidly recovered loss events" possibly defined by regulators.

Paragraphs 456k,l,m,n. We consider these definitions clear, useful (among other reasons because they consent to create a level playing field regarding loss event identification and classification) and consistent with the DIPO consortium policy (DIPO is the Italian Operational Losses Data Pooling Consortium).

Paragraph 457 It is unclear what is meant by "repeatability" of the scenario analysis process. By their nature, scenarios are subjective. In general, the paragraphs on scenarios should be written more flexibly so they do not imply any one given approach to scenario generation.

Paragraphs 459-460. Need to clarify these points, mainly with regard to the additional constraints it may rise with respect to other approaches more data based.

Paragraph 461c). Given the present depth of time series, the request of i.i.d in each "operational risk class" seems to prescriptive and very difficult to satisfy.

Paragraph 461d). The same holds also for this paragraph regarding stationarity. In addition, together with Annex 5, point 1, this provision on stationarity could be interpreted as also applied to kurtosis and/or skewness measures. Since the

existence of these two measures for OR should not be given for grant, it seems not to be appropriate to ask for their stationarity.

Paragraph 461n). Need to clarify how valuate the conservative of risk estimates in the absence of data.

Paragraph 461v). It seems that the document does not solve the problem of creating a "bridge" between IAS and CRD. The industry would welcome some more explicit solution in this regard. We ask for a text that clarifies that specific reserves for events that have already occurred will not qualify as allowable only if these events are exceptional. In fact following IAS37 all provisions/specific reserves (whether linked to exceptional events or not) should be recognized if and only if:
a) an entity has a present obligation (legal or constructive) as a result of a past event;
b) it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and
c) a reliable estimate can be made of the amount of the obligation.
This shows that previsions/specific reserves are by their nature linked to events that have already occurred and that this characteristic should not prevent them to be an EL off-set.

Paragraph 462a). It is the most critical paragraph. First of all there is an inconsistency with respect to CRD Annex X, Part 3, Paragraph 11 (§461x of CP10 revised). This paragraph of CRD states that the sum is a conservative and accepted measure. Instead in §462a there seems to be an exception to this conservative assumption. This could lead to situation in which a bank could be forced to calculate measures of correlation even if CRD Annex X Part 3, point 11 clearly states that this should not be the case unless a banks intends to validate its correlation measures.
In addition it seems to exist a contradiction between:

- 462a) and the example of Annex 8 "where a common factor generates simultaneous tail events in different classes (e.g. damage to physical assets or failure of IT data storage facilities)"

and

- 456K (multiple time losses and multiple effect losses have to be aggregated in on single event before entering in the calculation data set) and 461y, 461c, 461d (risk class i.i.d.).

In fact, once a banks has fulfilled the rules in the second bullet there is no risk of "simultaneous tail events in different classes" simply because only one loss will exist in one of the two ET considered in the example.

Again regarding the last paragraph of §462a) but in more technical language there seems to be a misunderstanding of the effects of dependences, as maximum dependence always implies comonotonicity (sum of the individual risk measures) whereas the upper bound (greater than the sum of the individual risk measures) stems from very peculiar dependency structures which present features as discontinuity etc.; in most cases indeed, comonotonicity appears to overestimate the aggregate risk. This is an example of the risk present in writing a very

prescriptive document on issues where an "academic standard", let alone an "industry standard", has not yet been established.

For all the above reasons we strongly suggest that Par 462a) should be deleted.

Paragraph 462c) Need to clarify the point "...institutions may wish to adjust their data for known drivers in order to simplify the modelling process". Is it referred to a scaling procedure?

Paragraph 462h) This paragraph stated that outsourcing can not be considerate as an "other risk transfer mechanism". Does this mean that a bank has to exclude from its calculation data set all the recoveries deriving from SLA with providers (i.e. the losses even if recovered by SLA should be inserted gross of recoveries)? It seems to be not acceptable since such a provision would discourage sound SLA policies.

Annex VIII. The 3rd paragraph is in open contrast with the CRD. Regulatory guidelines are supposed to provide an interpretation to the CRD or additional details rather than being an open critic to it. This Annex should be deleted.