ABI comments on the Basel Committee on Banking Supervision consultative document:
"Sound Practices for the Management and Supervision of Operational Risk"

February 2011

POSITION PAPER

2/2011

Introduction

The Italian Banking industry welcomes the initiative put forward by the Basel Committee to publish the consultative document “*Sound Practices for the Management and Supervision of Operational Risk*”.

In order to determine the position of the banking industry, the Italian Banking Association (ABI) has collected the various viewpoints of its Associates and their diverse proposals concerning the topics dealt with in that same document.

Based on the comments received, as well as by the activities carried out by interbank working groups, ABI has drafted the attached Position Paper, which is presented to the Basel Committee.

* CMI: C = Cancel, M = Modify, I = Insert

Par.	Subject / text)	C/M/I*	Comments to BCBS
16	**Third level of control** "*For smaller banks* this review and validation may be done by audit or by staff independent of the process or system under review, but may also involve other suitably qualified parties from external sources."	C	The supervisors' expectations for *bigger* banks are not made explicit at this point in the document. We suggest deleting the phrase here.
16, 18	**Third line of defence** "The third line of defence is an independent review and challenge of the bank's operational risk management controls, processes and systems. (…) Internal audit coverage should be adequate to independently verify that (..)"	M	This part should be consistent with the result of the consultation of the Paper bcbs184 ("Supervisory Guidelines for AMA") in order to avoid misunderstandings between verification and validation functions.
26-27	**Framework formalized in policies** "26. The Framework should be comprehensively and appropriately documented *in board of directors approved policies* and should include definitions of operational risk and operational loss. Banks that do not adequately describe and classify operational risk and loss exposure may significantly reduce the effectiveness of their Framework. 27. The policies defining the Framework should clearly: (a) identify the governance structures used to manage operational risk, including reporting lines and accountabilities; (b) describe the risk assessment tools and how they are used; (c) *describe the bank's accepted operational risk profile, permissible thresholds or tolerances for inherent and residual risk*, and approved risk mitigation strategies and instruments; (d) describe the bank's approach to establishing and monitoring thresholds or tolerances for inherent and residual risk exposure; (e) establish risk reporting and Management Information System (MIS); (f) provide for a common taxonomy of operational risk terms to ensure consistency of risk identification, exposure rating and risk management objectives11; (g) provide for appropriate independent review and assessment of operational risk; and (h) *require the policies to be revised whenever a material change in the operational risk profile of the bank occurs."*	M/C	Especially with reference to 27 sub (c), we question which level of detail policies should to be approved by the board of directors. These kinds of policies, approved by the board, should in principle be valid over a multi-year horizon and therefore can not address, with much detail, for example, specific thresholds. Similiarly, 27 sub (h), is not consistent with the "permanent" character of a Group-wide Policy: in case of a material change in the operational risk profile, a bank will probably decide to adapt its strategies, tactics, mitigation efforts etc., but should not change its basic rules defined in its Framework. The bank will simply apply its "universal" Framework to a changed reality – otherwise it would seem that, as the risk profile changed, the Framework must have been mistaken. Paragraph 27 requires that the high-level policies, those approved by the board of directors, should detail thresholds and tolerances related to inherent and residual risk exposure. It is understood that those thresholds and tolerances should be following the overall appetite and tolerance statement. It

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			seems here that asking the board to approve such a detailed structure is inappropriate and the role of the board should be lmited to approving the overall appetite statement.
Pr.4, Par. 30-31	**Risk appetite, limits** "Principle 4: The board of directors should approve and review a risk appetite and tolerance statement for operational risk that *articulates the nature, types and levels of operational risk* that the bank is willing to assume. 30. When establishing and approving a risk appetite and tolerance statement, the *board of directors* should consider all relevant risks, the bank's level of risk aversion, its current financial condition and the bank's strategic direction. The risk appetite and tolerance statement should *encapsulate the various operational risk appetites within a bank* and ensure that they are consistent. The *board of directors* should approve appropriate thresholds or *limits for specific operational risks, and an overall operational risk appetite* and tolerance. 31. The *board of directors* should regularly review the appropriateness of limits and the overall operational risk appetite and tolerance statement. This review should consider changes in the external environment, material increases in business or activity volumes, the quality of the control environment, the effectiveness of risk management or mitigation strategies, loss experience, and the frequency, volume or nature of limit breaches. *The board* should monitor management adherence to the risk appetite and tolerance statement and provide for timely detection and remediation of breaches."	M	Although we agree that the overall and Group-wide risk appetite for operational risk should be defined at Board level, we wonder whether regular review, detailed levels and reporting should not be managed in a sufficiently high-level committee like an OpRisk or Risk committee. Limit breaches or reviews can be referred? to the Board if and when deemed material. T he board of directors must approve appropriate thresholds or limits for specific operational risks, and an overall operational risk appetite and tolerance. Although a high level statement of risk tolerance and appetite (used here as synonyms) is definitely a responsibility of the board, the definition of limits is, on the one hand ,unproven?? given the nature of oprisk and on the other hand, far too detailed to be a matter for the board. Our suggestion here is to remove any reference to limits or thresholds from the board responsibilities. The same logic should be applied to para 31.
37	**Governance – Committees** "(b) Committee composition – Sound industry practice is for operational risk committees (or the risk committee in smaller banks) to include a combination of members with expertise in business activities, financial or risk management expertise and *independent non-executive board members*;"	M	The presence of independent non-executive board members in the Committee could be a suggestion but should not be a requirement.
42	**Review and approval process for business changes** "42. A bank should have policies and procedures that address the *process for review and approval of new products, activities, processes and systems*. The review and approval process should consider: (a) inherent risks in the new product, service, or activity; (b) resulting changes to the bank's operational risk profile and appetite	-	It would be interesting to know the BCBS's view on the level of authority the OpRisk function should have in these approval processes: a mere participating role, a voting right like other participating functions or a "veto" right.

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	and tolerance, including the risk of existing products or activities; (c) the necessary controls, risk management processes, and risk mitigation strategies; (d) the residual risk; (e) changes to relevant risk limits; and (f) the procedures and metrics to measure, monitor, and manage the risk of the new product or activity. The approval process should also include ensuring that appropriate investment has been made for human resources and technology infrastructure before new products are introduced. The implementation of new products, activities, processes and systems should be monitored in order to identify any material differences to the expected operational risk profile, and to manage any unexpected risks."		
55	**Insurance** "*The board of directors* should determine the maximum loss exposure the bank is willing to assume, and has the financial capacity to assume, and should perform an *annual review of the bank's risk and insurance management programme*. While the specific insurance or risk transfer needs of a bank should be determined on an individual basis, many jurisdictions have regulatory requirements that must be considered[20]."	C/M	- We do not see the necessity to give a review of the insurance programme to the Board each year if nothing fundamental changes; a senior Committee should be sufficient (like a Group OpRisk Committee or a Risk Committee). - The last phrase does not add much value. We suggest deleting it or putting it in a footnote. Move footnote 20 to paragraph 56.
56	**Risk transfer** "56. *Because risk transfer is an imperfect substitute for sound controls and risk management programmes*, banks should view risk transfer tools as complementary to, rather than a replacement for, thorough internal operational risk control."	M	We suggest deleting the first part (*in italic*) of the phrase as this is not entirely true; there will always be risks a bank can try to mitigate but it is not able to control completely (terrorism, earthquake, …). In fact, as correctly stated in the rest of the phrase, risk transfer is always done on the *residual risk, after* sound controls, risk management and mitigation programmes.