ABI comments on the Basel Committee on Banking Supervision consultative document:
“*Operational Risk – Supervisory Guidelines for the Advanced Measurement Approaches*”

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 "*Operational Risk – Supervisory Guidelines for the Advanced Measurement Approaches".*

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.

Regarding the issue of Pending Losses, please find enclosed a contribution of the Technical Committee of DIPO Association (Italian Database on Operational Risk Losses).

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

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3	**Introduction**	-	On page 1, para 3, the document states that the Guidelines are not reducing or superseding the discretion of National Supervisors, but intends to facilitate convergence of practices. As a consequence, some banks will need to amend their approved AMA practices and models to reflect these Guidelines. Clarification is strongly needed to highlight a common process to be followed in order to implement convergence homogeneously across the different jurisdictions. The same kind of argument to ensure consistency and level playing field across jurisdictions should be applied also to paragraph 5 on page 2.
13, 14, 16 and 44, 45, 70	**Governance – verification and validation** "Although operational risk management is still a relatively new risk framework, a variety of practices have been developed in several areas of internal governance, particularly in the governance structure used to manage operational risk. A bank's risk governance structure should be appropriate for its size and business complexity. The governance structure adopted by many banks relies on three lines of defence – business line management, independent corporate operational risk function, and independent verification and validation. The implementation of these three lines of defence varies depending on a bank's risk management approach and the flexibility provided by national supervisors.	I	Clarify whether it is acceptable for a banking group to have a centralised validation function (without local validation functions in the group entities). The division of responsibilities between **verification** and validation, i.e. the allocation of the various tasks between the two functions (addressed in para 14 – 16 and 44 – 70), seems too prescriptive. For instance, the checks of data inputs could very well be a joint effort of both the verification and validation functions and should not be confined to the validation only given that integrity of data in a lifecycle property that encompasses all phases of the production and use of data itself. A practical division of tasks could be verification monitors data origin and validation appropriateness of data usage.
17	**Use test and experience** "A bank may use various approaches to articulate and demonstrate the integrated use of its ORMF. The integrated framework should be updated regularly and evolve as the bank gains more experience in the management and quantification of operational risk. The level to which the broader ORMF processes and practices have been embedded at all organisational levels across a bank is referred to as "embeddedness". In addition to the initial period required by	-	Although recognizing the logical value of the concept of "embeddedness" an operating criterion to quantify its value would be welcome. Furthermore, and similarly to what was already commented on in the Sound Practices paper, **on para 77 page 18,** the board of directors is given the responsibility to approve not just the overall risk appetite and tolerance statement, but also a structure of limits and thresholds. This seems by far

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	supervisors as part of their use and embeddedness AMA assessment, the requirement is ongoing and banks will need to ensure that their ability to demonstrate embeddedness is not adversely impacted over time by change”.		too detailed to be allocated to the board and it is still to be proven that limits are meaningful in the context of OpRisk.
20	**Data** “… (3) scenario data and data related to a bank’s business environment and *(4)* internal controls.”	M	“… (3) scenario data and *(4)* data related to a bank’s business environment and internal controls.” (i.e., move “(4)”)
21 (and 83)	**Gross loss definition** “An operational risk loss can only arise from an operational risk event. The scope of operational risk *loss* refers to the type of events, whether or not having an impact on the financial statement, to be included in the operational risk database, and the purposes for which they are included (eg for management and/or measurement purposes).”	M	Not clear what the real intention is. A *loss* always has an impact on the financial statements, otherwise it is not a loss. Banks do however include in the database *events* that do not have an impact on financial statements. Change in: “… The scope of operational risk *event* refers to the type of events, whether or not having an impact on the financial statement, to be included in the operational risk database, …”
28 (and 128, 130, 132, 184)	**Reference dates** “28. An AMA bank may use any of the reference dates (occurrence date, discovery date, contingent liability date or accounting date) for building its calculation dataset, and for meeting minimum observation period requirements*, as long as material loss data is not omitted*.” “132 …a bank should carefully consider the time series used for the frequency and severity estimation and should incorporate *an observation period that limits the omission of any relevant loss data*.”	C	A bank should choose a proper reference date. Then, as a consequence of *whatever the choice is*, some material losses will be inside the dataset, others will be outside; “*as long as material loss data is not omitted*” really means a bank should capture major losses always and forever independent from any date or observation period. The last phrase of par. 132 states just so: a “relevant” loss should be captured always for as long as the bank exists, independently from the observation period. So, why then determine an observation period for “relevant losses” in the first place ? In this context, what is a “relevant” loss ?
29 (and 132, 185)	**Reference dates** “The discovery date or accounting date are the most prudent choices for developing a bank’s dataset for the quantification of the operational risk capital requirements related to that event. However, institutions may use occurrence date for building the calculation dataset *if the institution has not constrained or limited the observation period (ie five years).*”	M	It is not clear what is meant with: “*has not constrained or limited the observation period (ie five years)*” in par. 185. What is meant with “ie five years” ? This should already be the mandatory period for any kind of reference date. Further, it seems in contrast with par. 132: “*has not constrained or limited the observation period (ie less than five years)*”: does the bank need to consider at least five years or no period limitations at all?
35	**Distributional assumption** “…The risk measures should be monotonic, reasonable and be	-	In para 35, page 8, it is states that risk measures should be monotonic, but it is not specified with respect to what they

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	supplemented with information on their level of accuracy.”		should be monotonic. Taken literally, it means that risk measures should either always increase, or always decrease, forever, which obviously makes no sense.
36, 37	**Modelling: Scenario based approach** “36: (…) a few supervisory expectations and points of attention can be raised in order to make identification of distributions in SBA and LDA process more consistent with each other. Very often SBA curves are predetermined and the scenario data are only used to estimate the parameters of those distributions. While this approach is common in practice, what is seen with scepticism by supervisors is the use of the same curve, usually the Lognormal, for modelling the severity of the scenario data across all ORCs (…) 37: A more sound practice would be to envisage several distributions to be tailored to the different types and shapes of operational risk within the organization.”	I	For using SBA distributions consistent with LDA distributions (e.g. Lognormal + Generalized Pareto Distribution), SBA information (generally: frequency, average severity and worst case severity) might not be sufficient to estimate the number of parameters of these distributions. One should therefore use further information. Paras 36- 37, page 8 and paras 210-214 page 40,41: it is reasonable to use different distributions according to the complexity and the size of business, but when comparing SBA with LDA, the different level of granularity should be taken into account. For instance, let’s suppose that LDA has the operational risk categories (ORC) coinciding with the Basel Event Types at group level, whereas the SBA has a higher granularity (e.g. all event types for each organizational unit): even if each ORCs severity were model by the Lognormal distribution, then the resulting severity distribution isn’t, in general a Lognormal (at group level for Event Type). It can therefore be characterized by a heavier tailed behaviour than the Lognormal taking into account implicitly the complexity of the relevant business. Para 36 is too restrictive and in our opinion incorrect, when it states that such a choice implies that the risk profiles of all the ORCs of a bank are assumed to exhibit the same behaviour characterised by the same distribution. Even with 3 parameters (one for the frequency plus two for the lognormal severity) it is possible to describe quite different behaviours. We believe that it should be recognised that a Bank should be allowed to argue that the choice of a single distributional form is apt for the Bank’s particular implementation of Scenario Analysis.
42 (b)	**Use of the four data elements** “External Data (ED) - The Committee expects ED to be used in the	-	Even if it is true that most of external data are used to model loss severity, para 42 point (b) and para 252 should not be

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and 252	estimation of loss severity as such data contain valuable information to inform the tail of the loss distribution(s). ED is also an essential input into scenario analysis.” **External Data** ED is a natural complement to ILD in modelling loss severity in that it provides information on large actual losses that have not been experienced by the bank. Supervisors expect ED to be used in the estimation of loss severity as ED contains valuable information to inform the tail of the loss distribution(s). ED is also an essential input into scenario analysis as it provides information on the size of losses experienced in the industry.		interpreted as a bar for using external data to frequency mod elling, especially for specific rare events.
50	**Verification and Validation – roles** “Validation and verification activities comprise the bank’s challenge processes that provide independent assessments of ORMF and ORMS effectiveness. The effectiveness of the ORMF and ORMS should be reviewed by independent internal or external auditors and/or other independent parties. The purpose of these activities is to ensure that a bank’s ORMF is functioning as intended and that it remains appropriate for the bank’s risk profile. An independent challenge process is central to the establishment of an effective overall ORMF. *Verification and validation activities should encompass all components of the bank’s ORMF.* The depth and extent of validation and verification efforts should be consistent with the materiality and complexity of the risk being managed.”	M	We would like aconfirmation that there is no contradiction: what is meant by the italicized sentence is that all the ORMF components should be reviewed, either by verification or by validation. It should clarified that the two functions (verific necessarily ation and validation) do not have to review the same topics.
Fig. 1	**Figure 1, page 12**	C	The illustration is not very clear also considering what has been stated in the text. In particular, it seems that the same topics are reviewed by both the verification function and the validation function (policies, processes, governance).
57	**Validation activities** “(...) Qualitative aspects (including the internal controls, use test, reporting, role of senior management and organisational aspects);”	C	The text under point “b” point repeates a sub-point of “a”.
59	**Validation – organisational aspects** “The validation function should generally be carried out internally by qualified validation resources. However, supervisors recognise that this may present a challenge for some banks. While the outsourcing of verification and validation work is acceptable, the board and senior management are accountable for ensuring that outsourced functions are completed in a manner consistent with the bank’s	I	It could be specified that, in case of (international) Banking Groups with centralized risk measurement systems, acthe tivities carried out by centralized validation functions (e.g. at Parent Company level) are regarded as “internal”.

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	overall verification and validation plan."		
66	**Verification and Validation – Workplan** "*Verification plans*, including procedures that will be used to test the ORMF, should provide for the following expectations: (a) … (f); (g) *Audit* involvement or oversight. Verification and validation work plans should cover, at a minimum, the areas outlined above."	M	Change in: "Verification *and validation plans*, …" As "verification" is typically done by Audit already, item (g) seems out of place? Therefore probably the list should apply to both verification and validation, as confirmed by the final phrase of paragraph 66. Otherwise, it seems that a similar list is missing for the expectations for the Validation plan. More generally, there seems to be a bit of confusion – some activities are indicated for both validation and verification.
85	**Gross loss definition** "…(d) Pending bsses stem from operational risk events with a definitive financial impact, which are temporarily booked in transitory and/or suspense accounts and are not yet reflected in the statement on comprehensive income. For instance, in some countries, the impact of some events (eg legal events, damage to physical assets) may be known and clearly identifiable before these events are recognised through, the establishment of a reserve. Moreover, the way this reserve is established (eg the date of recognition) can vary across institutions or countries. "Pending losses", that are recognised to have a relevant impact, should be immediately included in the scope of operational risk loss; this can be done through the recognition of their actual amount in the loss database or pertinent scenario analysis.	C or M	In our judgment, the bank's choices in terms of loss amount evaluations for operational risk events in profit and loss account should come from the outcomes of the CFO's evaluations performed to represent the firm's economic results. That being stated, the inclusion of pending losses in gross loss computation and, in consequence, in the calculation dataset could be in contrast with the economic choices of the bank (a bank may not have reflected some pending losses in the statement on comprehensive income for specific internal economic evaluations). Moreover, including amounts which are not booked in the statement on comprehensive income could be in contrast with the definition of operational loss reported in some National documents as Circular document no. 263 of the Bank of Italy (Title II, chapter 5: "Operational risk loss": the negative economic effects resulting from operating events, identified in company accounts and are such that they have an impact on the Income Statement) Therefore we ask to delete point (d) para 85. If the proposed deletion should be unacceptable from a prudential point of view (assuming that there are non-optimal practices in transitory/suspense accounts management,) we propose working together by seeking the criteria upon which a sound and homogeneous treatment of pending could be based. We have toagree on a set of criteria to process PL that is not excessively onerous from a computational perspective and that is equilibrated from a prudential point of view. Even if we have not yet identified a solution, we offer a

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			suggestion to work on criteria like, time of entry and period of permanence of PL in the Transitory Account, type and amount of the account balance to be considered at the beginning and at the end of the period in order to decide if the PL has to be included or not in the calculation data set. (see attached Appendix 1 by DIPO, Italian Database on Operational Risk Losses). As a third alternative we suggest as following: para 85, poind d) states that pending losses of relevant impact should be included immediately in the scope of operational risk loss. Although it is agreed that pending losses related to operational risk events should be eventually included in the calculation dataset, the time lag for such inclusion should on the one hand, consider the impact of the loss and on the other hand, reflect the probability that an actual loss will be accounted for in the P&L. As such, the word "immediately" should be replaced by "within atime period commensurate to the size and age of the pending item".
87	"…(a) Timing losses are defined as the negative economic impacts booked in an accounting period, due to operational risk events impacting the cash flows ("lower cash in/higher cash out") of previous accounting periods. Timing impacts typically relate to the occurrence of operational risk events that result in the temporary distortion of an institution's financial accounts (eg revenue overstatement, accounting errors and mark-to-market errors). While these events do not represent a true financial impact on the institution (net impact over time is zero), if the error continues across two or more accounting periods, it may represent a material misrepresentation of the institution's financial statements. However, material "timing losses" due to operational risk events that span two or more accounting periods should be included in the scope of operational risk loss when they give rise to legal risk.	M	According to para 87, point a) material timing losses should be included in the scope of operational risk loss when they give rise to legal risk. We suggest adding that only the amount of the legal portion should, in the above case, be included in the calculation dataset.
88	**Measures of the gross loss amount** "(b) **Replacement cost**: the economic impact of an operational risk loss usually differs from the accounting impact when losses affect assets or accounts that are not maintained on a mark-to-market basis such as property, plant, equipment or intangible assets. The	C	In our judgment, the bank's choices in terms of loss amount evaluations for operational risk events in profit and loss account should come from the outcomes of the CFO's evaluations performed to represent the firm's economic results.

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	gross loss amount is the replacement cost of the item6. Replacement cost means the cost to replace an item or to restore it to its pre-loss condition.		That being stated, the calculation of gross loss amount through an impairment process could produce measures in contrast with the losses booked in the statement on comprehensive income. Moreover, including amounts which are not booked in the statement on comprehensive income in gross loss computation could be in contrast with the definition of operational loss reported in the Circular document no. 263 of the Bank of Italy (Title II, chapter 5: "Operational risk loss": the negative economic effects resulting from operating events, identified in company accounts and are such that they have an impact on the Income Statement)
99	**Gross loss amount vs. net** "A bank may use "gross loss amount" or "gross loss amount after all recoveries (except insurance)" as an input for its AMA models and *should demonstrate to its supervisor the rationale* for this choice."	M	It is not clear how to demonstrate this choice.
100	**Recoveries** "The bank should have a clear recovery estimate, regularly identifying the main recovery drivers and the aspects that may alter its recovery profile."	M	Please elaborate on what is meant by "recovery estimate". Only real, received recoveries are accounted for in the database. See also par. 101.
101	**Recoveries** "Conservatism is necessary, for example, following a significant loss event, where a bank receives recoveries after a considerable delay. During this timing lag "gross loss" may represent a material impact on the comprehensive income statement. The prevalent practice of "gross loss amount after all recoveries (except insurance)" as a model input should be rigorously challenged in these circumstances. For this kind of loss event, it may be more appropriate to use the "gross loss amount" even when those losses are fully recovered."	C/M	The point is not clear. The gross loss is recorded once incurred. It will remain at "gross loss" until the recovery is actually received; then it will be recorded as "net" loss (i.e., the gross loss minus the recovery). In paras 100 and 101, excessively burdensome requirements are imposed for the use of recoveries in the calculation dataset. Indeed, the determinants of recoveries are strictly related to the determinants of losses: so any changes that may alter the recovery profile will also alter the loss generating dynamics, making the relevance of the whole historical data analysis questionable. Furthermore, the conservatism required in para or par. BUT MUST BE CONSISTENT THROUGHT THE DOCUMENT 101 is excessive: lags between losses and recoveries may shift from one accounting period to another, but this happens on an ongoing basis, and the effects of those lagged recoveries should be considered in the current year.

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104	**Insurance recoveries** *"Insurance mitigation is in an early stage of development*. A bank should calculate the total operational risk capital charge gross of insurance recovery in order to determine the 20% limit and isolate the bank's methodology for modelling insurance mitigation."	M	The first phrase is incorrect with respect to the insurance industry. Substitute with: "*The recognition of insurance in operational risk capital models is in an early stage of development*."
109	**Internal loss data thresholds** "A bank may use different thresholds for data collection and modelling. A lower threshold may be desirable for risk management (*eg to examine internal fraud*) and expected loss calculation."	M	The example of "internal fraud" is not clear: internal fraud is typically low frequency, *high impact*. A lower threshold for risk management might be useful for *low impact events*, like external fraud. We suggest substituting "internal fraud" with "external fraud".
121	**Internal loss data threshold** "All operational losses above the set de minimis modelling threshold should be included in the calculation dataset and used, whatever their amounts, for generating the regulatory measures."	M	Para 121 seems very generic in its formulation, and it might even be in contrast with para 192, where the possibility of removing outliers is not ruled out.
122-129	**Date of Internal losses**	M	We see an inconsistency regarding the "observation period" mentioned in several paragraphs, as it is specified as "at least five years" in some places (e.g. para 29) and as "less than five years" in others (e.g. para 132).
127 135, 136	**Date of internal loss data** "…just over one-quarter of AMA banks use the *date of establishing a legal reserve* in the AMA capital charge calculation. Other dates used include settlement date (12%), *accounting date* (10%), …" **Legal exposure** "Because a legal exposure can change over time, a bank should include legal events as scenarios in the interim. That is, from discovery date until the date of accounting of the legal reserve, these events are recognised potential exposures that may potentially impact the bank's operational risk profile. A bank should also implement a robust process for updating legal event exposures between the reserve date and settlement date."	C C/M	The date of legal reserve is the same as the (first) accounting date, as stated also in par. 186, first line. Therefore it is not clear why a distinction has been made. A practical issue: for the time span before the first accounting, a scenario could be run. However, this scenario would be studied by the same experts (i.e., the legal department) that judged the legal claim to be without tangible risk in the first place and therefore decided not to provision anything so far. Consequently, the scenario result would be zero and would not resolve the issue. Para 135 is very prescriptive in the way it requires the inclusion as scenarios of legal events between discovery and accounting dates. This methodology might not even be in line with the modelling choices of an institution. We deem instead that the paper should suggest the inclusion of aforementioned events as scenario as an option to be used

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			when the legal event in question is not included in other ways.
154-155	**Grouping** "For a bank that uses internal loss data for modelling dependence/correlations, special consideration is needed, depending on the modelling method. The occurrence date, as opposed to the discovery date, should be utilised in the modelling of dependence/correlations."	M/C	Paragraph 154, page 32 suggests considering as the reference date for grouped losses that span over a long period of time not the first reference date of the underlying losses but instead the last one. We believe that this could introduce biases in the data (both internal and external) and, due to the potential updates in the underlying events, would not give certainty to the data. A more robust choice could be to enlarge the historical window (i.e. longer then the prescribed 5 years) for those types of event s(i.e. internal fraud) that are subject to this phenomenon. This solution would also resolve of the problem highlighted in para 155. If the rest of the modelling uses the accounting date or the discovery date as reference date, it would not be consistent to use the occurrence date to study the correlations. Further: is this paragraph referred only to the dependence within an ORC or also to the correlation among ORCs?
156	**Losses without causal relation** "A bank that groups small losses with no causal relations for data collection and registration purposes generally should not include them in its calculation dataset. If a bank chooses **not** include these losses in its calculation dataset, it should demonstrate that the use of this type of grouped losses does not materially distort the capital requirements calculation."	C	Typo: "A bank that groups small losses with no causal relations for data collection and registration purposes generally should not include them in its calculation dataset. If a bank chooses **to** include these losses in its calculation dataset, it should demonstrate that the use of this type of grouped losses does not materially distort the capital requirements calculation."
156-157	**Losses without causal relation** "..it should demonstrate that ….does not materially distort the capital requirements calculation"	–	A clarification would be appreciated on how a bank could demonstrate that the use/exclusion of grouped loss does not materially distort the capital requirements calculation if there is no accessible information about the single losses grouped in the bundle (no information about the number of the single events or dates)
158	**Losses without causal relation** "…the bank must approximate individual losses (eg inputting the number of grouped losses with an average loss amount assigned to each) and ensure that the effect of this approximation is immaterial to the calculation results"	-	A clarification would be appreciated on how a bank should behave if there is no accessible information about the single losses grouped in the bundle (no information about the number of the single events or dates) and it can't approximate individual losses in any way (for example a bank doesn't know the number of the events that are

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			included in the grouped loss or the time interval to spread the events for frequency analysis. For example, this latter case could cause distortions and peaks in the frequency distribution).
169	**Granularity** "A bank should support its choice of granularity by qualitative and quantitative means"	-	An illustrative list of some reasonable and satisfactory quantitative means to support the choice of granularity would be appreciated.
171	**Granularity** "A bank should use its choice of granularity as a gauge for capital allocation. When using a very high or very low number of ORCs, the allocated capital charges may not have the desired impact on the management of operational risk. When using an allocation method that is very different in nature from the choice of ORCs, the bank must ensure that its choice of ORCs or allocation method was reasonable in the first place."	M	We ask to soften this point and maintain it more as a suggestion. Although this would work in theory, we believe that in practice the dimensions for capital allocation and for risk classes can be quite different. For example, for allocating capital to minor legal entities: these will not have sufficient data points to make it a separate risk class.
192	**Building of the calculation Dataset** "On an exceptional basis, a bank may identify outliers (eg data that refer to abandoned business lines) within the calculation dataset"	M	In our judgment losses that refer to abandoned BL or products or processes should be excluded from the calculation dataset. A bank shouldn't calculate risk measures on abandoned activities. We request the following text modification: "On an exceptional basis, a bank may identify outliers (eg data that refer to abandoned business lines) within the calculation dataset"
222	**Determination of aggregated loss distributions and risk measures** "It is also crucial that the risk measures (while using conservative criteria and assumptions for prudential purposes) are realistic from a managerial and economic perspective. In specific cases, banks may **adopt** distributions that envisage the non-existence of the first moment (ie the mean), as this would result in high capital requirements and would not be easily and clearly justifiable and applicable within the firm**."**	M	**Para 222** contains a typo: the word "adopt" should be replaced with "**exclude**", otherwise the text is not self-consistent (since the non-existence of the mean determines capital requirements so high as to be non- justifiable and non- applicable, it should be allowed to avoid such cases).
252	**External data**	-	It should be better clarified that ED may have also other roles than providing" information on large actual losses ….".. Just to give some examples, ED may be useful in assess riskiness in new Business Lines or Areas, in benchmark analysis on recovery performance, in estimation of EL of competitors, etc.
253	**External data**	-	The risk of ED not fitting a particular bank's risk profile in indubitable but problems like bias of whichever sort can be

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			well managed if ED come from consortia in which the bank is actively involved (better awareness of criteria used in the data collection) .
254	**External data**		A sound filtering process can be provided by consortia. DIPO members can filter data not only on the basis of information related to the single bank that suffered the loss (dimensional cluster to which the affected bank belongs or kind of entity within a banking group, like leasing, commercial bank, etc) but also by MUT parameter computed for each member and each BL/ET cell. Given a specific BL/ET and period, MUT represents the mean of the losses' value under 90th percentile.
256	**Scenario analysis** "The scenario process is subjective by nature and therefore the outputs from a scenario process necessarily contain significant uncertainties. This uncertainty, together with the uncertainty from the other elements, should be reflected in *the output of the model producing a range for the capital requirements estimate.* Thus, scenario uncertainties provide a mechanism for estimating an appropriate level of conservatism in the choice of the final regulatory capital charge. Because quantifying the uncertainty arising from scenario biases continues to pose significant challenges, a bank should closely observe the integrity of the modelling process and interact closely with the relevant supervisor."	M	In a typical LDA model, the output of a scenario analysis is one additional data point in the tail of the severity distribution. Therefore, probably the phrase "…*reflected in the output of the model producing a range for the capital requirements estimate"* is more intended for models that rely more heavily on scenarios/SBAs ? Please clarify. Of the greatest importance for scenario analysis are qualitative external data regarding high impact events collected by consortia (for example DIPO AI, qualitative data flows with High Impact events provided by DIPO Consortium). If regulators agree, reference should be made to this kind of ED

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Appendix 1

CRITERIA TO IDENTIFY A METHODOLOGY FOR THE TREATMENT OF PENDING LOSSES

In 2009, CEBS published a Compendium of several guidelines on operating risk. With regard to the treatment of losses from Operating Risk, CEBS confirms that, beyond loss events that directly affect the Income Statement, external costs resulting from the loss event and specific provisions, "Pending Losses" (PL) that have a significant impact must also be considered in the calculation dataset of AMA banks.
These types of events are already assessed by several banks (AMA and others) that are DIPO Consortium members, and although said losses are not sent to DIPO as they are not defined as PEL, they are used for internal management purposes (for example, they are used in scenario building). Although the treatment of PL somewhat confounds accounting principles insofar as they are credits that in a certain sense are considered losses, we believe that the Consortium should contribute (through the involvement of the Technical Criteria Committee) to the debate that has also started in the regulatory sphere, by identifying any treatments that are sustainable from an accounting perspective, in operating terms and as regards adequacy with respect to effective risk.

This means that we have to agree on a set of criteria to process PL that is not excessively onerous from a computational perspective and that is reasonable from a prudential point of view.

Even if we have not yet identified a solution, we would like to suggest working on criteria similar to the following.

A) Envisaged **Definition of Pending Loss**

All amounts associated to operating risk events that are entered on transitory accounts or are suspended for more than 5 days[1] that have not yet had an impact on the Income Statement (in terms of both provisions and direct loss).

B) **Terminology** envisaged

1) With reference to the definition of transitory account, the following terms are specified:

- DEBIT BALANCE: algebraic sum of the movements of the DEBIT section of the transitory account

[1] Suspended amounts that are closed within 5 days of the date of the event fall within the definition of promptly recovered losses (see Circular Letter of the Bank of Italy No. 263 dated 26 December 2007). On this point, the DIPO Technical Committee has shown interest in further investigation once it has been established that the suspended amounts are not fully closed within 5 days (net PEL >0), the net PEL or gross PEL must be considered.

- CREDIT BALANCE: algebraic sum of the movements of the CREDIT section of the transitory account
- OVERALL BALANCE: balance of the DEBIT and CREDIT sections of the transitory account

2) Important dates

- START date of MONITORING of transitory account: date from which the PL is monitored according to the criteria;
- END data of MONITORING: Start of Monitoring plus X months: date on which, according to the criteria established, it is decided whether the PL is to be included in the calculation dataset and/or if it should be sent to DIPO.

3) Possible **alternative** criteria that could trigger monitoring

- when the DEBIT BALANCE becomes = the Y threshold to be established
- the first movement of the Transitory Account, whatever the amount

4) Possible **alternative** action at the end of monitoring. Namely the loss is considered in the calculation dataset and should be reported according to one of these alternative 3 criteria (or others to be established)

- the DEBIT BALANCE is = the threshold
- the OVERALL BALANCE is = the threshold:
- the OVERALL BALANCE is > zero

5) Reporting criteria

For example, in all cases to be reported, it could be established that the value to be entered in the PEL field is equal to the amount of the DEBIT BALANCE at the end of the monitoring period, and the value to be entered in the “Other Recoveries” field is equal to the amount of the CREDIT BALANCE.