ABI Associazione Bancaria Italiana

Position Paper in response to BCBS consultation on Operational Risk – Revisions to the simpler approaches

December 2014

POSITION PAPER

Index

Foreword

ABI and DIPO (Italian Database on Operational Risk Losses) welcome the opportunity to comment on the Basel Committee on Banking Supervision consultative document on Revisions to the simpler approaches for Operational Risk.

This Position Paper is based on comments received from our members.

General comments are made below. In addition there are also some specific comments related to individual articles.

The answers to questions 1-9 can be found at the end of the document.

General comments

1) We appreciate that the Committee agrees with the position taken by the banking industry since the outset, namely that the relevant indicators used until now do not provide a good estimate of operational risk. This is demonstrated by the fact that, in the event of a major decrease in income (or a loss) caused by a deterioration in the operational risk profile, the current relevant indicator suggests a decrease in the capital requirement, rather than a more appropriate increase.

2) We are concerned by the claimed "**average undercalibration**" obtained by applying the TSA, BIA and ASA requirements, and the ensuing underestimation of the AMA values obtained by using the requirements with the simplified methods as benchmarks. It would be helpful for **the Committee to provide explicit estimates of the level of undercalibration observed**, both for the TSA, BIA and ASA scope, and for the AMA scope, so as to allow banks to make a better assessment of the impact of the new calculation rules. For evidence of how the current requirements have proven to be prudent for the Italian Banking Sector, please see the answer to question Q4.

3) We need to understand fully whether there is a risk that increased costs borne by a bank in order to implement mitigation instruments might increase the value of the business indicator (BI), and thus increase its capital requirement in an indirect yet nonetheless proportional manner.

4) **In the new approach that is being established, there is certainly no reference to investments made with the aim of improving mitigation instruments**. We are aware that it would be complex to distinguish objectively how much of an investment is to be spent in support of new business and how much of that same investment is to cover the risks inherent in the activity. However we fail to understand why it is not possible to apply haircuts to such investments, so that they might, at least to a small extent, be recognized as elements deducted from BI, **thereby making the method more risk sensitive overall**.

5) The update to the Standardised Approach should also allow banks to **obtain recognition for the application** of a sound, prudent **provisioning policy** for covering expected operating losses in order to support this virtuous process.

6) We request that the **account items** factored into **BI** be **expressed** by reference **to IAS items** and their national equivalents, at least

for those **BI items corresponding to IAS ones** (e.g. Interest component can be expressed as IAS 10 and IAS 20). This terminology would allow better **comparability** within and between jurisdictions and greater **data quality**.

7) Regarding management of the **transitional period**, we would like to ask whether use of the basic (BIA) and standardised (TSA) methods, based on the "new relevant indicator" pursuant to Regulation (CRR) No 575/2013, has been confirmed until the new Standardised Approach (SA) enters into effect and is adopted as part of the EU standards?

Specific comments

Revisions to the operational risk standardised approaches

I. Background

Changes in the methods of calculating the capital requirement made during the year

Art. 314 of the CRR allows use of an advanced measurement method together with either the basic indicator approach (BIA) or the Standardised Approach. We would like confirmation that, at least in EU, it will still be possible to make combined use of AMA and SA, even if under some conditions/constraints. If this is not allowed any more, it would be necessary to give specific indications to Banks/Groups already adopting a **combined approach**. In addition, it would be useful to know how to manage **a change during the year in the method of calculation used** (change from SA to AMA)

II. Principles of the revised Standardised Approach (SA)

III. Elements of the revised SA

Dealing with banks facing specific situations

Net interest margin *(“NIM”)*: points 40 to 45 on page 15 of the consultation document relate to banks with a **very low or very high net interest margin - to what order of magnitude should we refer**?

Refinement of the proxy indicator of operational risk exposure

1) We appreciate the Committee's intention to use the BI as an indicator capable of capturing not merely an income-related factor, but rather the actual scope of the company's business, from various points of view.
In this regard, however, we have some thoughts to express, some of which have already been mentioned in the discussion of the relevant indicator.
The items **"Other operating income"** and "**Other operating expenses**" are aggregates that, in some cases, are not appropriate for inclusion in the estimate of operational risk, in that they do not seem correlated with a change in risk profile. In particular, we would like confirmation that, in addition to the items listed on page 19 of the consultative document, the following significant items for the Italian Banking Sector can also be excluded:

- Recoveries of stamp duty and taxes from customers for subsequent payment to the treasury
- Recoveries of wages for employees on secondment
- Insurance benefits (which are a form of risk mitigation and not an increase in the bank's risk profile)
- Non-recurring income and expenses

We request that the items indicated above be expressly **excluded from the BI.** Their elimination, on the basis of the list presented in Appendix I, should be based on the actual content of the accounts concerned, regardless of how they are actually handled (only administrative costs or expenses and not other income, etc.). **Summarizing, the general criteria would be to exclude all items relating to the recovery of administrative costs.**

It should also be clarified whether, in calculating the BI, the items within "Other operating income and expenses", as well as all other items comprising the service, should be taken individually as an absolute value or should, instead, maintain the sign with which are shown in the income statement.

2) Application of the BI to a **legal entity** subject to the CRD IV rules that belongs to a group also subject to those rules would result in **double counting** of some of the items considered: fee and commission income and expenses and rebates for other group companies, reimbursements for services rendered or recoveries of wages for employees on secondment within the group (a sort of internal outsourcing that ought to be considered on a par with external outsourcing, cited among the exclusions from the BI in Annex I). This could result in discrepancies in the size of the BI depending on the corporate organisation adopted by the group or individual bank. Accordingly, it is believed that the Committee should take account of

these aspects as input for the possible "further improvements" discussed in question Q3.

3) Evaluate the **correlation between fee and commission income and expense**, since, for example, in the case of fee and commission income for services rendered on payment systems, addition of the rebates granted to international circuits to the initial income component could result in **double counting** of the transactions, with the resulting overestimate of operational risk.

<u>Dealing with changes/recovery of the value of impaired financial assets/liabilities</u>

Considering the meaning of the different items of the BI and those explicitly excluded in the Consultation Paper, it would be appropriate to calculate the “Financial” macro-component of the BI taking into consideration the following Italian IAS income statement items:

Abs (Net P&L on TB) + Abs (Net P&L on BB)" =

Abs (80)+ Abs (90+100+110)

where

80. Net trading income
90. Net hedging income (loss)
100. Income from disposal or repurchase of loans and receivables, available-for-sale financial assets, financial liabilities.
110. Net income on financial assets and liabilities designated at fair value

<u>We would like explanations for the following cases which are addressed in the CRR but not in the BCBS consultative document.</u>

a) Treatment of income from extraordinary or irregular trades

No direction on how to identify the **scope of extraordinary and / or irregular trades** is given in the consultation document. Considering that these variables are not detectable in specific profit and loss items, it would be necessary **to specify if the BI calculation should refer to the “normalised’’ financial statements or to the standardised financial statements**. In our opinion, to provide stability for the model, it would be appropriate to consider the "normalised" financial statements and to define clearly what is meant by income from extraordinary or irregular trades (in general, it would be appropriate to exclude the out-of-period income/expense accounts).

b) Calculating the BI for periods of time shorter than 12 months (e.g. in the case of newly-formed banks, mergers and acquisitions)

It is **necessary to specify if the value of the BI should be annualised linearly on a monthly basis**, and if advance approval is required for this adjustment or if it can be made autonomously.

c) Calculating the BI in the event of a merger / acquisition of business segments during the year

In our opinion, the value of the BI should take into account the income statement items of acquired or merged operating segments, because they represent the projection of capital required for the following year.

d) Calculating the Business Indicator in case of division / disposal of business segments during the year

In our opinion, the components of profit or loss of sold/split business segments should not be considered because, having sold the business component, the related risk no longer exists. Therefore, if the model is to be used to calculate the capital base for the following year, exclusion is correct.

e) Scope of consolidation for budget purposes and scope of calculating the capital requirement for operational risk

If the scope of consolidation for budget purposes is broader than that used to calculate the capital requirement for operational risk, it should be clarified that the value used for the BI calculation must only refer to data related to the banking and financial institutions and business data included in the banking group, or consolidated on a proportional basis. It should also be clarified whether or not such data should also include income statement profits/losses on transactions with other companies that have been eliminated on consolidation.

Calculation of minimum capital requirements

We appreciate the envisaged progressive application of the calculation rules for the SA and the retention of the three-year average, which helps to attenuate abrupt discrepancies in the BI owing, for example, to especially significant non-recurring items.

Answers to Q1 to Q9

Q1. Are there any other weaknesses in the existing set of simple approaches that should be addressed by the Committee?

1) The development of an approach based on a single indicator of operational risk exposure with size-based coefficients **does not remove the weaknesses associated with Gross Income** (which assumes that the operational risk exposure of banks increases linearly in proportion to revenue).

2) The inclusion of items (e.g. "Profits/losses on the sale or repurchase of available-for-sale and held-to-maturity financial assets") **deriving from merely financial choices could have distorting effects** on the estimated absorption of operational risk.

Q2. Does a single standardised approach strike an appropriate balance across the Committee's objectives of simplicity, comparability and risk sensitivity?

1) The use of a single simplified approach, in addition to the AMA approach, would seem to satisfy the need for a proper balance between simplicity, comparability and sensitivity to risk. Considering that banks must nonetheless apply operational risk management processes and procedures in keeping with the PSMOR (the Committee's Principles for the Sound Management of Operational Risk), there are, however, doubts regarding **the complete absence of qualitative requirements for the simplified method, albeit basic and oriented towards the proportionality principle**, in this specific document of the Basel Committee. In fact, the result is a **large difference in the rules** (at a qualitative and potentially also a quantitative level) for **AMA and non-AMA banks**, which could provide incentives for continuing with the simplified approach.

2) On the subject of comparability in particular, it should also be noted that the income statements of Italian banks include within "Other operating income" their **recoveries of indirect taxes**, among other items. This component, which cannot strictly be regarded as income, has a non-marginal weighting and would result in a worse indicator with respect to the banks of other countries and **thus must be explicitly excluded, as already indicated in the QIS**.

Q3. Are there any further improvements to the BI that should be considered by the Committee?

In the new approach that is being established, there is certainly no reference to investments made with the aim of improving mitigation instruments. We are aware that it would be complex to distinguish objectively how much of an investment is to be spent in support of new business and how much of that same investment is to cover the risks inherent in the activity. However we fail to understand why it is not possible to apply **haircuts** to such investments, so that they might, at least to a small extent, be recognized as elements deducted from BI, **thereby making the method more risk sensitive overall**.

The update to the Standardised Approach should also allow banks to **obtain recognition for the application** of a sound, prudent **provisioning policy** for covering expected operating losses in order to support this virtuous process.

Q4. What additional work should the Committee perform to assess the appropriateness of operational risk capital levels?

"…An analysis conducted on the data from DIPO (the Italian Operating Loss Database) shows that, both on average and at the level of individual participants, the current regulations concerning the requirements for covering capital losses are sound and prudent. Accordingly, there does not appear to be any need for an indiscriminate increase in minimum capital to cover the losses deriving from operational risks. More compelling international supervisory action could have greater effects... [1]".
Considering, therefore, that the current operational risk requirement is consistent - in the Italian scenario - with the losses recorded, a significant increase would not be advisable. However, if there is a desire to achieve a general increase, **it will be important to be able to recover investments mitigating OR in order to render the method - while standardised - more risk sensitive**.

Q5. Are there any other considerations that should be taken into account when establishing the size-based buckets and coefficients? How many BI buckets would be practical for implementation while adequately capturing differences in operational risk profiles?

1) Five bucket classes represent a proper balance between an excessively large number and the need to obtain a certain degree of discrimination between the classes. However, it is currently not possible to assess if the progressive nature of the thresholds and rates chosen will be penalising, especially with regard to their application at individual level, to

[1] BANCARIA n. 7/8-2013

those legal entities belonging to a group that is also subject to the rules at consolidated level.

2) It would be more accurate to measure operational risk exposure by linking the coefficients to income statement items rather than by using coefficients based on the size of the bank.

3) With regard to the response given to question 4 concerning the avoidance of an indiscriminate minimum capital increase to cover the losses deriving from operational risks**, and** in order to **attenuate the impact** of the method in consultation, we propose that **changes be made to the coefficients, or to the increase in the threshold for the first bucket,** so as to contain the increase in the requirement, **especially for small and medium non-AMA banks**. This is also suggested by the IIF studies (”Results of the IIF WGOR Data Collection 2014”):

Table 9: Median Loss / Capital Ratio

	Assets of Bank	2004	2005	2006	2007	2008	2009	2010	2011	2012
BIA	< 500 BN		2.2%	3.1%	2.4%	2.0%	2.7%	2.3%	2.1%	2.2 %
	> 500 BN					6.1%	5.1%	8.6%	8.1%	8.0 %
TSA	< 500 BN			9.6%	5.6%	6.3%	7.6%	5.4%	4.7%	4.5 %
	> 500 BN					7.8%	5.7%	9.3%	10.7 %	9.3 %
AMA	< 500 BN		2.6%	22.7%	14.8 %	9.5%	9.8%	8.0%	6.9%	5.2 %
	> 500 BN						10.3 %	15.1 %	14.4 %	9.4 %

We also propose **gradual application over time** - a phase-in approach - of the change from TSA to BIA and SA, with "temporary" lower coefficients so as to avoid abrupt increases/jumps in the capital requirement for operational risks.

Q6. Are there any other considerations that should be taken into account when replacing business lines with size-based buckets?

1) We agree with the decision not to require the classification of income statement data by business line in the application of the Standardised Approach (SA).

2) However, we ask whether replacement of the BLs with size classes is also to be regarded as **complete abandonment of a business-line approach** to the **collection of loss data** (international level) and the

reporting of such data through the **ITS standard** or similar methods for the comparison of peer competitors?

Q7. Could there be any implementation challenges in the proposed layered approach?

The possible difficulties/challenges in implementing the proposed approach can only be evaluated after details have been established for the items to be included when determining the BI, with definitive exclusion (a possibility raised for certain types of extraordinary items) of the need for manual processing and other exclusions.

Q8. Do the issues of high interest margins and highly fee specialised businesses in some jurisdictions need special attention by the Committee? What could be other approaches to addressing these issues?

In order to avoid possible double counting of the same transactions, as indicated in point 3 of the section "Refinement of the proxy indicator of operational risk exposure," **we propose that a weighting coefficient or normalising factor be applied to fee and commission expenses**.

Furthermore, solely for institutions highly specialised in fee businesses, we propose considering **the difference between fee income and fee expense, instead of their sum.** These institutions could be identified as those for which fee expense exceeds x% of fee income, and/or the difference between fee income and fee expense exceeds y% of the Gross Income. In the Appendix we describe a specific case of an Italian Banking Group which includes a primary **Payment Institution** active in the credit card business, for which calculation of the BI using the sum of fee income and fee expense leads to a misleading and disproportionate capital impact.

We ask for the evaluation of similar mitigation actions or alternative methods for calculating the “Service Component” for those players focused on financial advisory work which, being highly specialised in fee business, face a “disproportionally high impact” triggered by the absolute value of the sum of the fee components.

Q9. What would be the most effective approach to promoting rigorous operational risk management at banks, particularly large banks?

The most effective approach would be something similar to AMA (without the requirements specific to the computation model) for large banks with qualitative requirements for AMA. In order to ensure a level playing field it would be necessary for these requirements to be specified centrally and not left to national discretion.

APPENDIX

THE ICBPI GROUP: Distinctive features of the core business of CartaSì (payment institution)

The ICBPI Group includes ICBPI (Bank and Parent Company), CartaSi (Payment Institution) and two ancillary companies (Oasi and Help Line).

All of the Group's core businesses (Payments, Securities Services – carried out by the Parent Company – and payment card – carried out by CartaSi) are "*highly fee specialised businesses*" (please see reference document, page 16, paragraph 46: "*A small number of banks that are highly specialised in fee businesses have been identified as facing a disproportionately high capital impact under the BI*"). This is shown by the fact that, during 2013, (net) fee contribution to Gross Income was approximately 80% of the total and fee contribution (fee income + fee expenses) to the Business Indicator was also about 80%.

As part of this structure, the Payment Institution CartaSi, which belongs to the ICBPI Group, makes a major contribution to the capital requirement for Operational Risk. The company exclusively operates in the payment card sector, which is the most significant business in terms of fees for the ICBPI Group. In fact**, in 2013, CartaSi generated 89% of the Group's fee and commission income and 94% of the Group's fee and commission expense.**

Specifically, the CartaSi business, on an individual basis, is governed in accordance with the relevant jurisdiction (*in some jurisdictions* – see point Q8 of the reference document) for Payment Institutions, the regulation of which is very different to bank regulation. In fact, the regulations governing a Payment Institution that is not included in a Banking Group specify significantly lower capital requirements (for both Credit Risk and Operational Risk) than those for banks and/or entities included in Banking Groups. In particular, with reference to the supervisory regulations for Payment Institutions (see the Regulations issued by Banca d'Italia on 20 June 2012), the own funds required by CartaSi to cover Operational Risk (method B under Directive 2007/64/EC on Payment Institutions[2]) are approximately 20 times lower than the Group Requirement calculated in accordance with the reference document. The Payment Institutions regulation is also less restrictive for Credit Risk, e.g. for such institutions the exposures related to charge cards (which represent about **96% of the credit cards issued** by CartaSi) have zero weighting, while the same waiver it is not extended to Banking groups.

[2] The other two methods (method A and method C) envisaged by the EU Directive and not applied by Banca d'Italia could lead to a Requirement that is respectively approximately 3 and 1.5 times higher than the Requirement calculated using method B. In any case, this is much lower than the contribution to the Group Requirement calculated in accordance with the reference document.

Given the characteristics of the CartaSi credit card management system, **the direct correlation between fee and commission income and expense** should be noted.

Fee and commission income consists of earnings obtained from card issuance, card transactions, revolving credit card interest, sales and cash management.

Fee and commission expense consists of “reimbursements” credited to Banks and interchange fees paid to international Circuits. These fees essentially involve transfer of **part of the revenues to Banks** and are governed by a special annex that is an integral part of the Agreement between Banks and CartaSi.

Consequently, it seems appropriate to **use a measurement of the volume of operations (net of ”reimbursements”), which could be the total of net fees and commissions, as a driver for calculating the Requirement.** Otherwise, in the specific case of CartaSi, it is methodologically incorrect to considering fee and commission expense as an additional element in the calculation of the capital requirement, since it represents a kind of risk transfer. Moreover, CartaSi credit cards are issued upon explicit request from Banks that autonomously authorize them and accept the related risks.
Based on of the foregoing and in accordance with the principles described in the reference document, the ICBPI Group, mainly due to the consolidation of CartaSi, **should be identified as a highly specialised payment service bank, in relation to which application of the BI has a disproportionate impact.**

In order to determine the requirement for the Operational Risks of the ICBPI Group, in accordance with the various options for banks with “very high or very low net interest margin” (page 15, paragraph 43), and considering the distinctive features of the CartaSi business compared with the typical activities of a banking institution, we propose the adoption of a “building block” approach by adding together the requirement applied to ICBPI (using the "Business Indicator" criteria) and that applied to the Payment Institution CartaSi (using "Method B" required by EU Regulation 2007/64/EC). If this solution is not applicable, **the difference between fee and commission income and fee and commission expense should be applied**. This approach would seem to be **more representative of the business volumes of the Group[3] with respect to summing the absolute values for fee and commission income and expense**.

Following this approach, the Capital Requirement would be essentially similar to the Requirement calculated in accordance with the Relevant

[3] Given the CartaSi’s significant contribution to the Group’s total fees and commissions

Indicator definition currently in use (EU Regulation 575/2013). Otherwise, there would be a threefold increase in the Requirement, which definitely does not represent the actual risk faced (see page 16, paragraph 46 of the reference document).