1

The development of ORM in UniCredit Group

1.1 A BRIEF HISTORY OF A FAST-GROWING GROUP

Nowadays, UniCredit Group is a large international banking group, serving millions of customers in many countries throughout the world. It provides full banking services and retail branches as well as wholesale commercial products for corporate clients, private banking, asset management and international investment banking. The group, though coming from one of the oldest Italian financial institutions, sustained major development from the mid-nineties, undertaking expansion into new markets, acquiring banks with a strong presence and deep roots. The changes have been so fast and continuous that UniCredit Group now can be included amongst one of the major banks in continental Europe and a leading player in many countries. The pace of change has been truly fast, and this has been possible thanks to a very clear strategy and execution capacity, as well as strong and experienced management. It has also been achieved, we believe, thanks to a strong risk management culture, with great attention to process control. This has been a key driver in the operational risk management process. UniCredit management has been and remains extremely focused on monitoring and risk assessment, and rather than hindering the development of operational risk control, starting from the top management levels, there has been immediate and full sponsorship of investment and strengthening of the operational risk management function. This has been a success factor in ensuring the highest quality service to clients, retaining them and gaining market share, adding to reputation and at the same time making sure that product distribution impacts in terms of costs and risk are available to business management.

UniCredit has incorporated many banks and financial service firms in recent years, creating a worldwide company that needs to control complex processes in a timely manner. Together with its development, it was necessary to ensure that operational risk was kept under control, so that

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strategy execution could be ensured. Especially under increasing market and regulatory scrutiny, ensuring operational risks were well managed became *paramount*. The difficulties of monitoring risk exposure in such a fast-changing and diversified group were compensated by an increased management need to ensure control and regular monitoring of operational risks. The investments necessary were, and remain, relevant, and we will describe these further on, but the Group management realized it was necessary, so the great difficulties and challenges we faced, and still are tackling, find strong support and commitment at the highest management level.

1.2 CREATING A NEW FUNCTION

For many financial institutions operational risk management has been a new requirement introduced with the 2001 Basel Capital Accord first consultative paper. It was then that banking regulators, reviewing banks' risk management requirements, introduced the operational risk concept. They proposed a definition, still subject to interpretation problems and open issues, as we will explain in the following chapter. It required that a dedicated operational risk control function was necessary. In many banks, operational risk control types were not concentrated and assigned to a unique function. Rather, operational risk control was assigned various processes and entailed the involvement of many functions. Internal auditors, information technology departments, security officers, credit underwriters, human resource managers, companies' own real estate administrations, accountants, planners and many others were managing operational risks. The new capital accord required that a dedicated process and function coordinate and monitor those types. With the exception of a few international banks, it meant for many financial institutions a brand new process, defining responsibilities, relations with other departments, developing control tools, recruiting and training staff. In short, building probably one of the most complex control processes, starting from zero and without any benchmark or reference to rely on. In the marketplace, advisory and experienced operational risk managers in the early years were not available, nor were there IT systems specifically designed for operational risk control.

The first problem to solve was identifying the new function's rules and responsibilities. We dedicated our very first efforts writing the operational risk management rulebook, indicating in detail the new risk manager tasks, the interactions with other functions and the Group headquarters risk department. For UniCredit group, it was paramount to outline the individual companies' operational risk manager interactions and responsibilities towards the Group risk management consolidating function. The rulebook, reviewed by internal audit and other internal functions responsible for compliance, was approved by the Group risk committee and Board of Directors as the first stepping stone in the new process.

1.3 DEVELOPING THE NEW CONTROL SYSTEM

Unlike market risk, for operational risk there was no JP Morgan's *Riskmetrics*, nor any commonly recognized benchmarking methodology available. The new Basel accord, unlike credit risk, didn't provide detailed instructions to banks on how to measure or control operational risk, provided an open approach, with generic requirements, principles more than specific rules. This was very stimulating and encouraging on one side, but left many uncertainties on how control processes and measuring methodologies should be developed. The lack of standard measurement methodologies and tested control tools benchmark control processes and specific literature on the subject – was the common challenge for banks willing to adopt advanced measurement approaches for operational risk management. It also wasn't clear whether using advanced solutions would result in capital relief or actual control advantages. The sole indications available then were the first exercises performed by international regulators on operational loss data collection, *LDC*. These had been the foundations for the understanding of banks' operational risk exposure assessment by regulators, begun in 2001 and based on the assumption that a bank's operational risk is directly correlated to certain loss type. We will discuss and present our view on such assumption: one should take into account that the first LDC results were not quite satisfactory, as most banks started collecting operational loss types just after the New Basel Capital Accord first consultative paper in 2001.

The new operational risk function goal was to gather loss data, providing, indications to risk manager, audit, back office, HR, accountants, of what was needed. This was relatively straightforward for thefts, robberies, real estate damages, but it became a challenging and complex matter when we came to settlement losses or IT damage. The latter were small amount damages, often difficult to obtain or quantify.

1.4 CHALLENGES IN THE EARLY STAGES

We summarized the problems in the early stages of the operational risk framework development: no methodologies, no benchmarking approach, no experienced operational risk managers, no common understanding of how to set up the control process, no literature available, no specific indications from regulators, no tools available in the market, limited specialized consultancy. These factors combined made the start-up phase extremely complex, as it clearly demanding experienced project managers.

Ensuring regular control of operational risks for a group the size of UniCredit required a dedicated IT tool. In 2001 specific operational risk tools were not available in the market. We required a system that could gather information from UniCredit-specific procedures and databases. We opted then for an in-house software development solution operational risk management and control tool, with the related database. This resulted in a group wide application, distributed to all risk managers in all the countries and companies where UniCredit operates. The first application developed was engineered by the operational risk management team, supported by UniCredit IT development. The core architecture, still in the current operational risk system, defined distinct areas or modules, dedicated to loss data collection, risk indicators, scenario analysis, and operational process mapping. This then became an optional functionality, as we found the exercise of representing companies' processes cumbersome and difficult to maintain, with limited value added. The modules were released and distributed to operational risk managers at different stages, allowing feedback from users for further development.

1.5 METHODOLOGY TO MEASURE OPERATIONAL RISK

The greatest problem in measuring operational risk is that its very definition leaves lots of uncertainties on the interpretation of what constitutes operational risk and what it is instead, a credit market risk or simply a procedure adjustment (e.g. contra entries). We believe, this still represents the biggest challenge in measuring operational risk, as the final results will affect banks' capital. We perceive a rift between those convinced operational risk is correctly measured only based on losses, as these reflect entirely and completely a bank's exposure, and those believing operational losses are not actually either timely or fully indicative of the bank's operational risk, advocating other elements to be considered. We think that losses are usually only related to some of the operational risks, and very likely many operational problems do not translate into actual losses. We argue that accounted losses will be booked with significant delays to the events' occurrence, especially for large claims and major problems, the ones possibly having a major impact in determining the capital at risk. Some instead support their thesis on accounted operational loss validity, claiming that banks will gather years-long time series, allowing on one side the identification of reporting and booking delays, and on the other side permitting the improvement of timely booking.

1.6 TRAINING AND INTERNAL COMMUNICATION FOCUS

For us probably the greatest hurdle in the early stages was defining and explaining the operational risk concept. Often misunderstood as an additional further audit level, it required reiterated efforts to explain its peculiar role and identity. The internal communication was addressed at all levels proving to be a very time consuming exercise. There were no dedicated training courses available, so these also needed structuring: Training courses had to be designed to meet different types of requirements, providing introduction to the operational risk concept to all staff. We developed an entry level course accessible and easy to understand for people with very different working experience and know-how, from cashier to client relationship managers. We designed first a web-based introductory course, presenting key Basel concepts and then proceeding with an operational risk definition, the operational risk control function role, and its interaction with the other organizational structures. In the entry level course, provided to all Group's employees, the staff could learn the elementary operational risk concepts and foundations, including loss data collection, the course was then updated, but its purpose of providing a brief description of operational risk's, regulatory and process requirements still remains.

Once addressed the generic training for all employees, we provided specific training to the newly recruited operational risk managers. Again, there were no specific courses available, and we were actually developing measurement methodologies and control processes. The first specialized internal courses for operational risk managers focused on loss data classification and collection. Newly appointed operational risk managers were chosen amongst bankers with the most varied experience: internal audit, retail branch managers, trading, back office, accounting, etc. initially we asked them to analyze the profit & loss accounts booking and to identify and report operational type losses. For people who had never worked in accounting and weren't familiar with it, this wasn't an easy task, especially in a large group like UniCredit, with large retail branch operations, international investment banking, wholesale and asset management in many countries. Focus of our operational risk manager training is first to understand the profit & loss accounts logic, learning about IAS and IFRS principles and rules, consolidating accounting and general ledger. Rather than delegating it to the accounting department or some external consultants, we always preferred to assign these controls to the operational risk management. We attribute the greatest value to loss data completeness – we are convinced it helps to understand the company risk exposure and processes, it allows the operational risk managers to interact with many departments, and it gives an insight into possible operational exposures.

1.7 INTERNATIONAL REGULATORY CHALLENGES

UniCredit group is listed on Borsa Italiana, the Italian stock exchange, the consolidating regulator is the Bank of Italy, while the group controls, in its turn, banks and financial services in more than twenty countries, entailing very complex relations.

The new Basel capital accord implies that at individual country level there is an implementation directive, a regulation interpreting the Basel principles and guidelines, complying with national binding regulation and existing principles.

Ensuring consistent control over operational risks demands common methodologies, systems, rules, and standards. We believe the best approach was applying to controlled companies minimum common operational control standards, but allowing operational risk managers and companies to integrate these standards with additional specific controls like ad hoc reporting or analysis, when necessary for business or additional domestic regulatory requirements. This flexibility proved, a success factor: it allowed individual businesses to develop operational risk controls to reflect their peculiar structure and processes, bespoke analysis and reporting, providing also useful feedback and suggestions for improvement of the control framework. It also stimulated an open dialogue with regulators, facilitating integration of companies that already developed their own operational risk management framework.

An increasingly critical issue we faced was identifying the appropriate external loss data, given UniCredit group business structure and markets. We started with DIPO (Database Italiano di Perdite Operative), an Italian banks' loss data consortium. Even though still participating, as UniCredit became increasingly an international group, we needed a data source reflecting the operational risk exposure. We began collecting from publicly available data sources, newspapers, and internet newswire operational reported losses suffered by financial institutions. This was a repetitive and toilsome exercise, taking precious time away from staff. Eventually we decided on Algo operational loss data, an external provider. The data was provided by an international company, so ensuring service quality and reliability, also for auditing and validation guaranteeing loss data reporting independence.

1.8 REPUTATIONAL RISK MANAGEMENT

In recent times, with the increasing complexity of UniCredit Group and its growing. The operational risk management analyzed the reputational impacts of Group's products and businesses. Strictly linked to operational risk, the management of reputational risks hinges on internal process control, and the assessment of markets, clients' and communities' expectations. The focus on service efficiency takes into account long-term impact on results and environment; that's where we found useful the experience developed with operational risk control, applied to reputational impact.

Looking at international events that occurred to financial institutions, we found that many operational risks could have a paramount reputational impact, often larger than the loss or the inadequate service provided. Certain events could have major market and press relevance, with the company's management subject to unexpected levels of scrutiny, or the company's ethics or service quality. In recent years, due to major changes driven by consolidation and competition, the banking industry experienced increased attention by markets and media, sometimes questioning pricing and product distribution policy, risk appetite, and returns. As banks offer a service to markets and clients, experience high regulatory attention, being, are a structural component of this industry sector. As a consequence inadequate reputational risk control and management, relaxed or weak risk monitoring, can, sooner or later, be perceived by customers, resulting not in worse results but also damage to the company's reputation. Banks build their customer base on reputation, and it must be a management priority to maintain and enhance it.