

Operational risks

Qualitative information

General aspects, procedures for the management and methods for the measurement of operational risk

It is Group policy to identify, measure and monitor operational risks within an overall process of operational risk management with the following objectives:

- to identify the causes of prejudicial events at the origin of operational losses and consequently to increase corporate profitability and improve operational efficiency, by identifying critical areas and monitoring and optimising the system of controls;
- to optimise policies to mitigate and transfer risk, such as for example, the use of insurance, on the basis of the magnitude and actual exposure to risk;
- to optimise the allocation and absorption of capital for operational risk and provision policies in a perspective of creating value for shareholders;
- to support decision-making processes concerning the start up of new business, activities, products and systems;
- to develop an operational risk culture at business unit level increasing awareness throughout units;
- to respond to the regulatory requirements of the New Basel Accord on Capital for banks and banking groups.

In the light of the regulatory context as set out by the Bank of Italy in the publication of Circular No. 263 of 27/12/2006, the UBI Banca Group will adopt the standard TSA (Traditional Standardised Approach) in combined use with the basic BIA (Basic Indicator Approach) method for the calculation of capital requirements on operational risks in 2008, to converge in 2009 on the use of an internal model of the advanced type (Advanced Measurement Approach-AMA) in combined use with the TSA and BIA method (partial AMA, where “partial” is intended as the adoption of the AMA method on some lines of business or Group entities only).

Operational risk is defined as the risk of loss resulting from inadequate or failed procedures, human resources and internal systems or from exogenous events. This type of risk includes loss resulting from fraud, human error, business disruption, system failure, non performance of contracts and natural disasters.

This definition includes the legal risk of losses resulting from violations of laws and regulations, and from contractual or non contractual responsibilities or from other litigation, but it does not include reputational risk.

Operational risk is characterised by cause and effect relations for which one or more trigger events generate a prejudicial event or effect which is directly linked to an economic loss.

An operational loss is therefore defined as a set of negative economic impacts resulting from events of an operational nature, recognised in the accounts of a business and sufficient to impact on the income statement.

Processes for the management and methods for the measurement of operational risk

Following the merger, the new Group policies for managing operational risk were defined and activities were completed to align and integrate the organisational model for the management and monitoring of operational risk, of processes and systems for the measurement of operational losses (loss data collection) and of risks connected with potential loss events (self risk assessment).

The organisational model

Operational risk permeates the whole organisational structure and is found in every function and organisational unit. An organisational model was therefore designed to manage it which assigns tasks and responsibilities at both local and central level of the legal entities involved in the Group as a whole. An Operational Risk Committee was formed at the Parent Bank with policy-making and supervision duties for the overall process of operational risk management, while a specific service is also in operation within the Risk Management Area dedicated to the planning, development and maintenance of methods for detecting, measuring and monitoring operational risk and for verifying the effectiveness of measures to mitigate it and of the connected reporting systems. Within the Risk Capital and Policies Area, there is also a Financial Service and Operational Risk Policies Service, responsible, in co-operation with the other organisational units concerned, for defining policy for the management, monitoring and mitigation of operational risk including policies for insurance risk management and for the Models and Processes Validation Service responsible for the validation process.

The organisational model is structured with four levels of responsibility for the individual legal entities of the Group.

- *Operational Risks Officer (ORO)*
They are responsible within their legal entities for implementing the overall framework for the management of operational risks.
- *Local Operational Risk Support Officer (LORSO)*
The main role acting in support of the Operational Risk Officer to implement the general process of the management of operational risks in the single entities to which they belong.
- *Risk Champion (RC)*
Operationally responsible for supervising the operational risk management process for the purposes of overall validation in their business areas, co-ordinating and supporting the relative risk owners. They support the risk monitoring process and participate in the definition and implementation of mitigation strategies;
- *Risk Owner (RO).*
Their task is to recognise and report actual and/or potential operational loss events which occur or are detected in the course of everyday operations. They participate in the implementation of corrective or improvement action decided at higher levels designed to reduce exposure to risk.

Methods and systems of measurement

The operational risk management system of the Group is composed of the following:

- a decentralised process for collecting data on operational losses (loss data collection) designed for integrated and systematic detection of damaging events that occur which result in an actual loss. Operational losses are periodically reconciled in the accounts and updated in real time by risk owners and/or risk champions by means of a software application available on the Group intranet, which shows any recoveries that are obtained separately, including those resulting from specific insurance policies.
- a structured process for mapping and assessing risk scenarios (risk assessment) intrinsic to the business areas of the Group, supported by a software application for integrated management, where the intention is to furnish critical operational self diagnosis of potential exposure to the risk of future losses, of the adequacy of controls and of the mitigation measures in place.
- a database of operational losses incurred by the sector nationally since 2003. The Group has participated in the DIPO (Italian database of operational losses) project launched by the ABI (Italian Banking Association) to exchange loss data in the sector since it commenced.

- a system for measuring economic and supervisory capital to calculate the absorption of supervisory capital by operational risk for each business unit using a standardised method. Following the integration of the processes for the measurement of operational losses and for mapping and assessing risk scenarios, analysis activities were started to develop an internal model to determine the risk exposure of the new Group using a loss distribution approach.

Reporting

A reporting system is used in the monitoring of operational risks which furnishes the information needed to manage and mitigate the levels of risk assumed by the Group.

The reporting system is structured with the same levels of responsibility employed by the organisational model to support the multiple information requirements intrinsic to the federal model of Group organisation. The objective is to guarantee standardised information and allow periodical verification of the operational risks assumed so that management strategies and objectives can be defined that are consistent with levels of risk considered acceptable.

Reporting to corporate bodies, the senior management of the Parent Bank and of the network banks and to the Operational Risks Committee is periodically performed centrally by the Operational Risks Service. It includes an analysis at differing degrees of detail according to requirements of the following: an analysis of data on internal losses and the relative recoveries together with a comparison with external data for the sector nationally; the results of the assessment of risk exposure with the identification of areas of vulnerability; and a description of the action to undertake to prevent and mitigate risk and of the relative effectiveness.

Legal risk

The companies in the UBI Banca Group are party to a number of court proceedings of varying nature originating from the ordinary performance of their business. While it is not possible to predict final outcomes with certainty, it is considered that an unfavourable conclusion of these proceedings, both taken singly or as a whole, would not have a significant effect on the financial and economic position of the UBI Banca Group.

Legal proceedings to which some UBI Group member companies are party include bankruptcy revocatory actions currently pending initiated by Parmalat Spa in extraordinary administration with a claim amounting to 246.521.984 euro.

In order to meet the claims received, the UBI Banca Group felt that it was appropriate to make a provision as at 31st December 2007 of 18.479.885 euro on the basis of a reconstruction of the amounts potentially at risk of revocation which took account of established legal opinion on the matters in question.

Quantitative information

Descriptive data

The graphs below show that the main sources of operational risk for the UBI Banca Group in the period January 2004-December 2007 were “external context” (57% of the impacts and 84% of the frequencies) and “processes” (28% of the impacts and 14% of the frequencies).

The “external context” risk drivers included human deeds performed by third parties and not directly under the control of the Bank, such as for example thefts and robberies, paper fraud, damage caused by natural events (earthquakes, floods, etc.) and other external events. The “process” risk drivers included unintentional mistakes, insufficiently trained personnel, procedural and process inefficiencies and the failure to comply with procedures and internal controls.

The changes that occurred in the impacts gross of insurance and other external recoveries showed an annual trend for operational losses in the period 2004–2007 in constant improvement, down from 16 million euro in 2004 to 6 million euro in 2007. The occurrence frequencies decreased during the period from 1.549 events in 2004 down to 1.424 events in 2007.

The types of event which caused the greatest losses in the period 2004-2007 (gross of insurance recoveries and other external recoveries) were “external frauds” (48%), “customers, products and professional practices” (15%) and “execution, delivery and management of processes” (14%) and they were mainly attributable to the “retail banking” line of business.

The data for the banking sector as a whole (DIPO-ABI Association) for the period January 2003-June 2007 show losses concentrated in the event classes “customers, products and professional practices” accounting for 37%, “external fraud” and “internal fraud” for 20% and in the Basel line of business class “retail banking”, accounting for 44%.

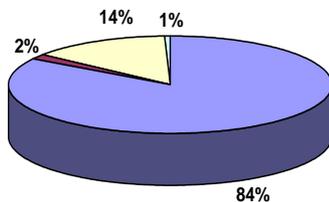
The UBI Banca Group accounts for a total of 4,1% of the frequencies and 2,1% of the impacts in the DIPO-ABI Association database.

As a percentage of gross income operational losses of the network banks of the Group for a unit amount >= 5.000 euro occurring in the period January 2004-September 2007 recorded an improvement with an average value of 0,27% compared to an average for the sector nationally (DIPO-ABI Association) of 0,57%.

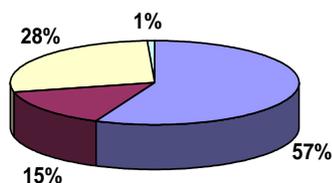
Graph of percentage of operational losses that occurred in the period Jan 2004-Dec 2007

Percentage by risk driver

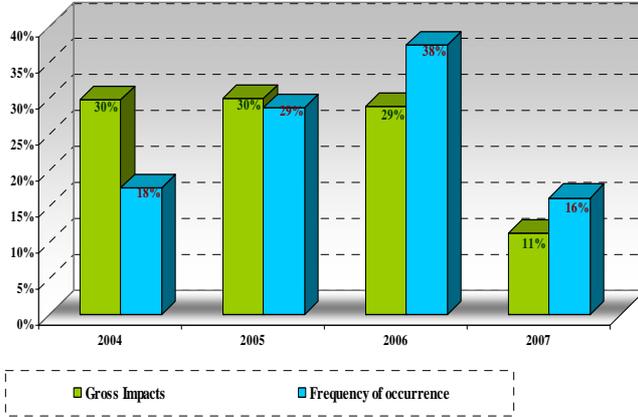
Frequencies



Impacts

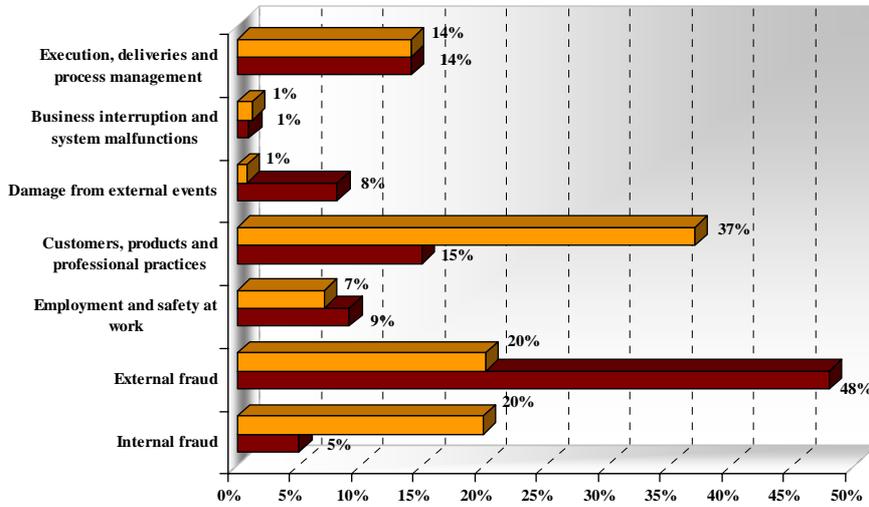


Distribution by year of occurrence

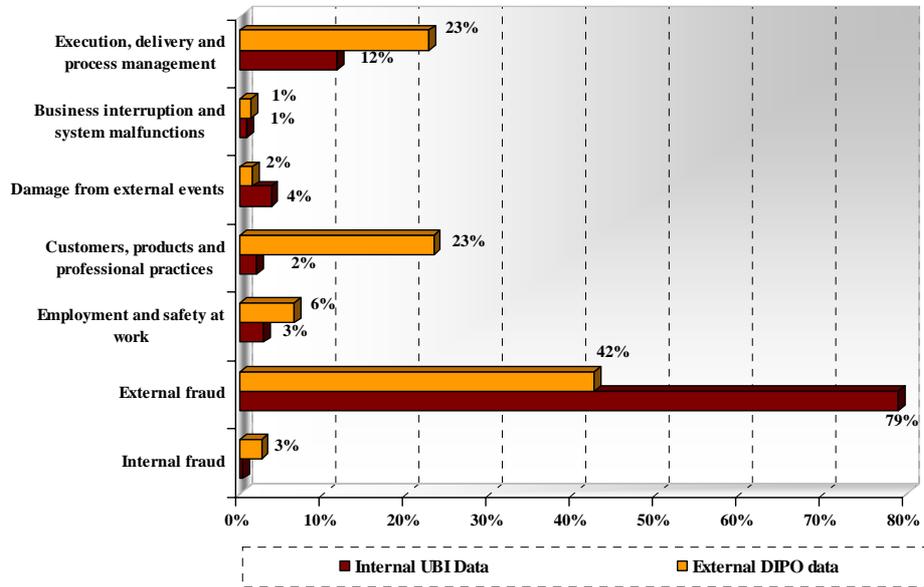


Percentage by type of event

Impacts



Frequencies



The five greatest impacts that occurred – sector data compared with Group data

DIPO-ABI Association, period January 2003 - June 2007

Business Line	Event Type Lev. I	Impact	Recoveries
Commercial Banking	Internal fraud	99.408.550	28.000.000
Commercial Banking	Customers, products and professional practices	90.832.089	0
Commercial Banking	Customers, products and professional practices	82.606.437	0
Commercial Banking	Customers, products and professional practices	25.080.000	0
Retail Brokerage	Customers, products and professional practices	22.643.547	7.600.000

UBI Banca Group, period January 2004 - December 2007

Business Line	Event Type Lev. I	Impact	Recoveries
Retail Banking	Internal fraud	1.641.149	0
Retail Brokerage	Customers, products and professional practices	934.622	0
Retail Banking	Customers, products and professional practices	650.000	0
Retail Banking	External fraud	636.803	0
Retail Banking	Employment and safety at work	550.000	0