

purchasing organization is unable to assign an internal risk rating to each of the purchased accounts. The capital charge for dilution risk would be calculated using the wholesale risk weight function with some additional specified risk inputs.

The AMA for Operational Risk

Under the A-IRB approach, capital charges for credit risk would be directly calibrated solely for such risk and, thus, unlike the 1988 Accord, would not implicitly include a charge for operational risk. As a result, the Agencies are proposing that banking organizations operating under the A-IRB approach also would have to hold regulatory capital for exposure to operational risk. The Agencies are proposing to define operational risk as the risk of losses resulting from inadequate or failed internal processes, people, and systems, or external events. Under the AMA, each banking organization would be able to use its own methodology for assessing exposure to operational risk, provided the methodology is comprehensive and results in a capital charge that is reflective of the operational risk experience of the organization. The operational risk exposure would be multiplied by 12.5 to determine a risk-weighted assets equivalent, which would be added to the comparable amounts for credit and market risk in the denominator of the risk-based capital ratios. The Agencies will be working closely with institutions over the next few years as operational risk measurement and management techniques continue to evolve.

Other Considerations

Boundary Issues

With the introduction of an explicit regulatory capital charge for operational risk, an issue arises about the proper treatment of losses that can be attributed to more than one risk factor. For example, where a loan defaults and the banking organization discovers that the collateral for the loan was not properly secured, the banking organization's resulting losses would be attributable to both credit and operational risk. The Agencies recognize that these types of boundary issues are important and have significant implications for how banking organizations would compile loss data sets and compute regulatory capital charges.

The Agencies are proposing the following standard to govern the boundary between credit and operational risk: A loss event that has characteristics of credit risk would be

incorporated into the credit risk calculations for regulatory capital (and would not be incorporated into operational risk capital calculations). This would include credit-related fraud losses. Thus, in the above example, the loss from the loan would be attributed to credit risk (not operational risk) for regulatory capital purposes. This separation between credit and operational risk is supported by current U.S. accounting standards for the treatment of credit risks.

With regard to the boundary between the trading book and the banking book, for institutions subject to the market risk rules, positions currently subject to those rules include all positions held in the trading account consistent with GAAP. The New Accord proposed additional criteria for positions includable in the trading book for purposes of market risk capital requirements. The Agencies encourage comment on these additional criteria and whether the Agencies should consider adopting such criteria (in addition to the GAAP criteria) in defining the trading book under the Agencies' market risk capital rules. The Agencies are seeking comment on the proposed treatment of the boundaries between credit, operational, and market risk.

Supervisory Considerations

The advanced approaches introduce greater complexity to the regulatory capital framework and would require a high level of sophistication in the banking organizations that implement the advanced approaches. As a result, the Agencies propose to require core and opt-in banks to meet certain infrastructure requirements and comply with specific supervisory standards for credit risk and for operational risk. In addition, banking organizations would have to satisfy a set of public disclosure requirements as a prerequisite for approval to using the advanced approaches. Supervisory guidance for each credit risk portfolio type, as well as for operational risk, is being developed to ensure a sufficient degree of consistency within the supervisory framework, while also recognizing that internal systems will differ between banking organizations. The goal is to establish a supervisory framework within which all institutions must develop their internal systems, leaving exact details to each institution. In the case of operational risk in particular, the Agencies recognize that measurement methodologies are still evolving and flexibility is needed.

It is important to note that supervisors would not look at compliance with

requirements, or standards alone. Supervisors also would evaluate whether the components of an institution's advanced approaches are consistent with the overall objective of sound risk management and measurement. An institution would have to use appropriately the advanced approaches across all material business lines, portfolios, and geographic regions. Exposures in non-significant business units as well as asset classes that are immaterial in terms of size and perceived risk profile may be exempted from the advanced approaches with supervisory approval. These immaterial portfolios would be subject to the general risk-based capital rules.

Proposed supervisory guidance for corporate credit exposures and for operational risk is provided separately from this ANPR in today's **Federal Register**. The draft supervisory guidance for corporate credit exposures is entitled "Supervisory Guidance on Internal-Ratings-Based Systems for Corporate Credit." The guidance includes specified supervisory standards that an institution's internal rating system for corporate exposures would have to satisfy for the institution to be eligible to use the A-IRB approach for credit risk. The draft operational risk guidance is entitled "Supervisory Guidance on Operational Risk Advanced Measurement Approaches for Regulatory Capital." The operational risk guidance includes identified supervisory standards for an institution's AMA framework for operational risk. The Agencies encourage commenters to review and comment on the draft guidance pieces in conjunction with this ANPR. The Agencies intend to issue for public comment supervisory guidance on retail credit exposures, equity exposures, and securitization exposures over the next several months.

Supervisory Review

As mentioned above, the second pillar of the New Accord focuses on supervisory review to ensure that an institution holds sufficient capital given its overall risk profile. The concepts of Pillar 2 are not new to U.S. banking organizations. U.S. institutions already are required to hold capital sufficient to meet their risk profiles, and supervisors may require that an institution hold more capital if its current levels are deficient or some element of its business practices suggest the need for more capital. The Agencies also have the right to intervene when capital levels fall to an unacceptable level. Given these long-standing elements of the U.S. supervisory framework, the Agencies