

The Agencies are proposing the AMA to address operational risk for regulatory capital purposes. The Agencies are interested, however, in possible alternatives. Are there alternative concepts or approaches that might be equally or more effective in addressing operational risk? If so, please provide some discussion on possible alternatives.

A. AMA Capital Calculation

The AMA capital requirement would be based on the measure of operational risk exposure generated by a banking organization's internal operational risk measurement system. In calculating the operational risk exposure, an AMA-qualified institution would be expected to estimate the aggregate operational risk loss that it faces over a one-year period at a soundness standard consistent with a 99.9 percent confidence level. The institution's AMA capital requirement for operational risk would be the sum of EL and UL, unless the institution can demonstrate that an EL offset would meet the supervisory standards for operational risk. The institution would have to use a combination of internal loss event data, relevant external loss event data, business environment and internal control factors, and scenario analysis in calculating its operational risk exposure. The institution also would be allowed to recognize the effect of risk dependency (for example, correlation) and, to a limited extent, the effect of insurance as a risk mitigant.

As with the proposed A-IRB capital requirement for credit risk, the operational risk exposure would be converted to an equivalent amount of risk-weighted assets for the calculation of an institution's risk-based capital ratios. An AMA-qualified institution would multiply the operational risk exposure generated by its analytical framework by a factor of 12.5 to convert the exposure to a risk-weighted assets equivalent. The resulting figure would be added to the comparable figures for credit and market risk in calculating the institution's risk-based capital denominator.

Does the broad structure that the Agencies have outlined incorporate all the key elements that should be factored into the operational risk framework for regulatory capital? If not, what other issues should be addressed? Are any elements included not directly relevant for operational risk measurement or management? The Agencies have not included indirect losses (for example, opportunity costs) in the definition of operational risk against which institutions would have to hold capital; because such losses can be substantial, should they be included in the definition of operational risk?

Overview of the Supervisory Criteria

Use of the AMA would be subject to supervisory approval. A banking organization would have to demonstrate that it has satisfied all supervisory standards before it would be able to use the AMA for risk-based capital purposes. The supervisory standards are briefly described below. Because an institution would have significant flexibility to develop its own methodology for calculating its risk-based capital requirement for operational risk, it would be necessary for supervisors to ensure that the institution's methodology is fundamentally sound. In addition, because different institutions may adopt different methodologies for assessing operational risk, the requirement to satisfy supervisory standards offers some assurance to institutions and their supervisors that all AMA-qualified institutions would be subject to a common set of standards.

While the supervisory standards are rigorous, institutions would have substantial flexibility in terms of how they satisfy the standards in practice. This flexibility is intended to encourage an institution to adopt a system that is responsive to its unique risk profile, foster improved risk management, and allow for future innovation. The Agencies recognize that operational risk measurement is evolving rapidly and wish to encourage continued evolution and innovation. Nevertheless, the Agencies also acknowledge that this flexibility would make cross-institution comparisons more difficult than if a single supervisory approach were to be mandated for all institutions. The supervisory standards outlined below are intended to allow flexibility while also being sufficiently objective to ensure consistent supervisory assessment and enforcement of standards across institutions.

The Agencies seek comment on the extent to which an appropriate balance has been struck between flexibility and comparability for the operational risk requirement. If this balance is not appropriate, what are the potential areas of imbalance and what is the potential impact of the identified imbalance?

The Agencies are considering additional measures to facilitate consistency in both the supervisory assessment of AMA frameworks and the enforcement of AMA standards across institutions. Specifically, the Agencies are considering enhancements to existing interagency operational and managerial standards to directly address operational risk and to articulate supervisory expectations for AMA frameworks. The Agencies seek comment on the need for and effectiveness of these additional measures.

The Agencies also seek comment on the supervisory standards. Do the standards

cover the key elements of an operational risk framework?

An institution's operational risk framework would have to include an independent operational risk management function, line of business oversight, and independent testing and verification. Both the institution's board of directors and management would have to have responsibilities in establishing and overseeing this framework. The institution would have to have clear policies and procedures in place for identifying, measuring, monitoring, and controlling operational risk.

An institution would have to establish an analytical framework that incorporates internal operational loss event data, relevant external loss event data, assessments of the business environment and internal control factors, and scenario analysis. The institution would have to have standards in place to capture all of these elements. The combination of these elements would determine the institution's quantification of operational risk and related regulatory capital requirement.

The supervisory standards for the AMA have both quantitative and qualitative elements. Effective operational risk quantification is critical to the objective of a risk-sensitive capital requirement. Consequently, a number of the supervisory standards are aimed at ensuring the integrity of the process by which an institution arrives at its estimated operational risk exposure.

It is not sufficient, however, to focus solely on operational risk measurement. If the Agencies are to rely on institutions to determine their risk-based capital requirements for operational risk, there would have to be assurances that institutions have in place sound operational risk management infrastructures. In addition, risk management elements would be critical inputs into the quantification of operational risk exposure, that is, operational risk quantification would have to take into account such risk management elements as the quality of an institution's internal controls. Likewise, the AMA capital requirement derived from an institution's quantification methodology would need to offer incentives for an institution to improve its operational risk management practices. Ultimately, the Agencies believe that better operational risk management will enhance operational risk measurement, and vice versa.