

Corporate Governance

An institution's operational risk framework would have to include an independent firm-wide operational risk management function, line of business management oversight, and independent testing and verification functions. While no specific management structure would be mandated, all three components would have to be evident.

The institution's board of directors would have to oversee the development of the firm-wide operational risk framework, as well as major changes to the framework. Management roles and accountability would have to be clearly established. The board and management would have to ensure that appropriate resources have been allocated to support the operational risk framework.

The independent firm-wide operational risk management function would be responsible for overseeing the operational risk framework at the firm level to ensure the development and consistent application of operational risk policies, processes, and procedures throughout the institution. This function would have to be independent from line of business management and the testing and verification functions. The firm-wide operational risk management function would have to ensure appropriate reporting of operational risk exposures and loss data to the board and management.

Lines of business would be responsible for the day-to-day management of operational risk within each business unit. Line of business management would have to ensure that internal controls and practices within their lines of business are consistent with firm-wide policies and procedures that support the management and measurement of the institution's operational risk.

The Agencies are introducing the concept of an operational risk management function, while emphasizing the importance of the roles played by the board, management, lines of business, and audit. Are the responsibilities delineated for each of these functions sufficiently clear and would they result in a satisfactory process for managing the operational risk framework?

Operational Risk Management Elements

An institution would have to have policies and procedures that clearly describe the major elements of its operational risk framework, including identifying, measuring, monitoring, and controlling operational risk. Management reports would need to be developed to address both firm-wide and line of business results. These reports would summarize operational

risk exposure, operational loss experience, and relevant assessments of business environment and internal control factors, and would have to be produced at least quarterly. Operational risk reports, which summarize relevant firm-wide operational risk information, would also have to be provided periodically to senior management and the board. An institution's internal control system and practice would have to be adequate in view of the complexity and scope of its operations. In addition, an institution would be expected to meet or exceed minimum supervisory standards as set forth in the Agencies' supervisory policy statements and other guidance.

B. Elements of an AMA Framework

An institution would have to demonstrate that it has adequate internal loss event data, relevant external loss event data, assessments of business environments and internal control factors, and scenario analysis to support its operational risk management and quantification framework. These inputs would need to be consistent with the regulatory definition of operational risk. The institution would have to have clear standards for the collection and modification of operational risk inputs.

There are a number of standards that banking organizations would have to meet with respect to internal operational loss data. Institutions would have to have at least five years of internal operational risk loss data captured across all material business lines, events, product types, and geographic locations.⁵⁰ An institution would have to establish thresholds above which all internal operational losses would be captured. The New Accord introduces seven loss event type classifications; the Agencies are not proposing that an institution would be required to internally manage its operational risk according to these specific loss event type classifications, but nevertheless it would have to be able to map its internal loss data to these loss event categories. The institution would have to provide consistent treatment for the timing of reporting an operational loss in its internal data systems. As highlighted earlier in this ANPR, credit losses caused or exacerbated by operational risk events would be treated as credit losses for regulatory capital purposes; these would include fraud-related credit losses.

⁵⁰ With supervisory approval, a shorter initial observation period may be acceptable for institutions that are newly authorized to use an AMA methodology.

An institution would have to establish and adhere to policies and procedures that provide for the use of relevant external loss data in the operational risk framework. External data would be particularly relevant where an institution's internal loss history is not sufficient to generate an estimate of major unexpected losses. Management would have to systematically review external data to ensure an understanding of industry experience. The Agencies seek comment on the use of external data and its optimal function in the operational risk framework.

While internal and external data provide an important historic picture of an institution's operational risk profile, it is important that institutions take a forward-looking view as well.

Consequently, an institution would have to incorporate assessments of the business environment and internal control factors (for example, audit scores, risk and control assessments, risk indicators, *etc.*) into its AMA capital assessment. In addition, an institution would have to periodically compare its assessment of these factors with actual operational loss experience.

Another element of the AMA framework is scenario analysis. Scenario analysis is a systematic process of obtaining expert opinions from business managers and risk management experts to derive reasoned assessments of the likelihood and impact of plausible operational losses consistent with the regulatory soundness standard. While scenario analysis may rely, to a large extent, on internal or, especially, external data (for example, where an institution looks to industry experience to generate plausible loss scenarios), it is particularly useful where internal and external data do not generate a sufficient assessment of the institution's operational risk profile.

An institution would be required to have a comprehensive analytical framework that provides an estimate of the aggregate operational loss that it faces over a one-year period at a soundness standard consistent with a 99.9 percent confidence level. The institution would have to document the rationale for all assumptions underpinning its chosen analytical framework, including the choice of inputs, distributional assumptions, and weighting of quantitative and qualitative elements. The institution would also have to document and justify any subsequent changes to these assumptions.

An institution's operational risk analytical framework would have to use a combination of internal operational loss event data, relevant external