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## I. Purpose

The purpose of this guidance is to set forth the expectations of the U.S. banking agencies for banking institutions that use Advanced Measurement Approaches (AMA) for calculating the operational risk capital charge under the new capital regulation. Institutions using the AMA will have considerable flexibility to develop operational risk measurement systems appropriate to the nature of their activities, business environment, and internal controls. An institution's operational risk regulatory capital requirement will be calculated as the amount needed to cover its operational risk at a level of confidence determined by the supervisors, as discussed below. Use of an AMA is subject to supervisory approval.

This draft guidance should be considered with the advance notice of proposed rulemaking (ANPR) on revisions to the risk-based capital standard published elsewhere in today's **Federal Register**. As with the ANPR, the Agencies are seeking industry comment on this draft guidance. In addition to seeking comment on all specific aspects of this supervisory guidance, the Agencies are seeking comment on the extent to which the supervisory guidance strikes the appropriate balance between flexibility and specificity. Likewise, the Agencies are seeking comment on whether an appropriate balance has been struck between the regulatory requirements set forth in the ANPR and the supervisory standards set forth in this guidance.

## II. Background

Effective management of operational risk is integral to the business of

banking and to institutions' roles as financial intermediaries. Although operational risk is not a new risk, deregulation and globalization of financial services, together with the growing sophistication of financial technology, new business activities and delivery channels, are making institutions' operational risk profiles (*i.e.*, the level of operational risk across an institution's activities and risk categories) more complex.

This guidance identifies the supervisory standards (S) that institutions must meet and maintain to use an AMA for the regulatory capital charge for operational risk. The purpose of the standards is to provide the foundation for a sound operational risk framework, while allowing institutions to identify the most appropriate mechanisms to meet AMA requirements. Each institution will need to consider its complexity, range of products and services, organizational structure, and risk management culture as it develops its AMA. Operational risk governance processes need to be established on a firm-wide basis to identify, measure, monitor, and control operational risk in a manner comparable with the treatment of credit, interest rate, and market risks.

Institutions will be expected to develop a framework that measures and quantifies operational risk for regulatory capital purposes. To do this, institutions will need a systematic process for collecting operational risk loss data, assessing the risks within the institution, and adopting an analytical framework that translates the data and risk assessments into an operational risk exposure (see definition below). The analytical framework must incorporate a degree of conservatism that is appropriate for the overall robustness of the quantification process. Because institutions will be permitted to calculate their minimum regulatory capital on the basis of internal processes, the requirements for data capture, risk assessment, and the analytical framework described below are detailed and specific.

Effective operational risk measurement systems are built on both quantitative and qualitative risk assessment techniques. While the output of the regulatory framework for operational risk is a measure of exposure resulting in a capital number, the integrity of that estimate depends not only on the soundness of the measurement model, but also on the robustness of the institution's underlying risk management processes. In addition, supervisors view the introduction of the AMA as an

important tool to further promote improvements in operational risk management and controls at large banking institutions.

This document provides both AMA supervisory standards and a discussion of how those standards should be incorporated into an operational risk framework. The relevant supervisory standards are listed at the beginning of each section and a full compilation of the standards is provided in Appendix A. Not every section has specific supervisory standards. When spanning more than one section, supervisory standards are listed only once.

Institutions will be required to meet, and remain in compliance with, all the supervisory standards to use an AMA framework. However, evaluating an institution's qualification with each of the individual supervisory standards will not be sufficient to determine an institution's overall readiness for AMA. Instead, supervisors and institutions must also evaluate how well the various components of an institution's AMA framework complement and reinforce one another to achieve the overall objectives of an accurate measure and effective management of operational risk. In performing their evaluation, supervisors will exercise considerable supervisory judgment, both in evaluating the individual components and the overall operational risk framework.

An institution's AMA methodology will be assessed as part of the ongoing supervision process. This will allow supervisors to incorporate existing supervisory efforts as much as possible into the AMA assessments. Some elements of operational risk (*e.g.*, internal controls and information technology) have long been subject to examination by supervisors. Where this is the case, supervisors will make every effort to leverage off these examination activities to assess the effectiveness of the AMA process. Substantive weaknesses identified in an examination will be factored into the AMA qualification process.

## III. Definitions

There are important definitions that institutions must incorporate into an AMA framework. They are:

- **Operational risk:** The risk of loss resulting from inadequate or failed internal processes, people and systems, or from external events. The definition includes legal risk, which is the risk of loss resulting from failure to comply with laws as well as prudent ethical standards and contractual obligations. It also includes the exposure to litigation from all aspects of an institution's