Basel II
Advanced Measurement Approaches (AMA) for Operational Risk

Supervisory Expectations

May 2003
What is Operational Risk?

Operational risk is the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events.

- Internal fraud
- External fraud
- Employment practices & workplace safety
- Clients, products & business practices
- Damage to physical assets
- Business disruption & system failures
- Execution, delivery & process management

- Includes legal risk.
- Excludes reputational and business/strategic risk.
What is an AMA?

- Capital requirement is based on bank’s internal operational risk measurement system.
- Focuses on both measurement and management of operational risk.
- Requires supervisory approval based on qualitative and quantitative standards.
- Consistent with sound and rapidly evolving industry practices.
Why the AMA?

- Provides sensitivity (in contrast to simple approaches for calculating risk-based capital).
- Promotes improved risk management.
- Encourages innovation.
- Attempts to balance need for flexibility (to foster continued innovation) with the need for consistency of application.
Required Elements of an AMA

- A bank’s internal operational risk measurement system must take into account the following elements:
  - Internal data
  - External data
  - Scenario analysis
  - Internal control and business environment factors

- The measurement system may also factor in the following elements:
  - Risk mitigation (e.g., insurance)
  - Correlations

- These elements can be combined in different ways to quantify exposure to operational risk.
Qualifying Criteria

- Four broad areas will be assessed:
  - Operational risk corporate governance
  - Operational risk loss data
  - Risk quantification
  - Risk mitigation
Operational Risk
Corporate Governance

- Board and senior management oversight.
- Independent enterprise-wide operational risk framework and function.
- Policies and procedures for all aspects of the operational risk framework.
- Independent testing & verification (e.g., audit).
- Lines of business responsible for day-to-day risk management.
- Reporting of operational risk exposures, losses, risk indicators, etc., to board and senior management.
- Sound internal control environment.
Operational Risk Loss Data

- Collect internal operational loss data.
- Refer to relevant external loss data to understand industry experience with respect to large losses.
- Map to the seven event types (but not required to use the seven event types for internal purposes).
- Identify drivers of operational risk and how changes in the risk management and/or control environments affect risk profile.
Risk Quantification

- Data elements combined to quantify operational risk exposure at a designated confidence level.
- Assess likelihood and severity of “tail events”.
- Scenario analysis must be incorporated into quantification.
- Correlations must have sound underpinning.
Risk Mitigation

- May take into account the risk mitigating effect of insurance.
- Subject to criteria:
  - Ability/willingness of insurer to pay;
  - Third-party risk transfer;
  - Maps to actual operational risk loss events;
  - Minimum cancellation & non-renewal periods.
- Even where criteria are met, coverage should be discounted to reflect uncertainty of payment.
Supervisory Guidance for AMA

- Will be structured around qualifying criteria.
- Attempt to make clear supervisory objectives.
- Should allow non-Basel banks to better assess and understand the AMA framework in choosing whether or not to opt in.
- Prescriptive where appropriate, but generally allows for considerable flexibility.
Next Steps

- Issue supervisory guidance for AMA this summer (with ANPR)
- Likely visitations with some banks in late 2003 or early 2004 to benchmark industry practices.
- Supervisory guidance will evolve based on visitations and developments within the industry.
- To qualify for AMA at year-end 2006, banks need internal data starting January 1, 2004.