DATE: July 11, 2003

MEMORANDUM TO: Board of Directors

FROM: Michael J. Zamorski
Director
Division of Supervision and Consumer Protection

SUBJECT: Basel II Capital Accord
Supervisory Guidance on Operational Risk Advanced Measurement Approaches for Regulatory Capital

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Proposal: That the Board of Directors of the Federal Deposit Insurance Corporation (Board) approve publication of the attached joint Supervisory Guidance on Operational Risk Advanced Measurement Approaches for Regulatory Capital (Guidance) in the Federal Register for a 90 day comment period. The Guidance details qualifying criteria and expectations for banking institutions using the Advanced Measurement Approach (AMA) to calculate an operational risk capital charge under the proposed New Capital Accord being developed by the Basel Committee on Banking Supervision. The Guidance would be issued on an interagency basis by the FDIC, the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision (Agencies). The Guidance seeks industry and public comment and is intended to supplement the Advance Notice of Proposed Rulemaking regarding *Risk-Based Capital Guidelines; Internal Ratings-Based Capital Requirement* (ANPR).

Recommendation: That the Board approve issuance of the Guidance.

Concur:

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William F. Kroener, III
General Counsel

Background: In the ANPR, the Agencies present the New Capital Accord's operational risk capital charge as part of a revised risk-based capital rule for large, internationally active banks. The operational risk charge will be combined with credit risk and market risk capital to determine minimum regulatory capital requirements.

Operational risk exists in the natural course of financial activity, but methodologies for quantification of the risk are not as well developed as those for credit risk or market risk. The evolving methods for quantifying operational risk lack universal agreement; nevertheless, significant advancement is becoming increasingly evident. To promote further evolution and innovation in the measurement of operational risk, the Agencies have integrated considerable flexibility in the attached guidance. The Agencies believe that a Pillar 1 minimum regulatory requirement in the New Capital Accord will provide significant incentive to the industry to further develop this important and significant risk area.

Discussion: The Agencies are proposing guidance and qualifying criteria that set forth the expectations for banking institutions using the Advanced Measurement Approach (AMA) to calculate an operational risk capital charge. 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. Thus, the Agencies view the introduction of the AMA as an important means for promoting improvements in operational risk management through heightened assessment of exposure, and implementation of better controls at large banking institutions.

Institutions are granted substantial flexibility to choose a methodology for calculating the risk-based capital requirement for operational risk. This flexibility is intended to encourage an institution to adopt a system that is relevant to its unique risk profile, fosters improved risk management, and allows for future innovation. Nevertheless, the Agencies' believe the criteria are sufficiently objective to ensure integrity of the process. Further, supervisory approval will be required before an institution can begin using its system to determine minimum regulatory capital for operational risk.

Operational Risk Defined

Operational risk is defined as the risk of loss resulting from inadequate or failed internal processes, people, and systems or from external events. These risks are further defined as follows:

- Process risk – breakdown in established processes, failure to follow processes or inadequate process mapping within business lines.
- People risk – management failure, organizational structure or other human failures, which may be exacerbated by poor training, inadequate controls, poor staffing resources, or other factors.
- Systems risk – disruption and outright system failures in both internal and outsourced operations.
- External event risk – natural disasters, terrorism, and vandalism.

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 activities. The definition does not include strategic and reputational risks.

AMA Capital Calculation

The capital requirement will be based on the operational risk exposure generated by an institution's internal operational risk measurement system. Institutions must incorporate each of the following elements into its analytical framework to quantify its exposure to operational risk.

- Internal loss data;
- Relevant external loss data;

- Assessments of internal controls and the business environment; and
- Scenario analysis.

In calculating the operational risk exposure, the institution will be expected to estimate the aggregate operational losses that it faces over a one-year period at a soundness standard consistent with a 99.9% confidence level. The institution's capital requirement for operational risk will be the sum of expected and unexpected losses, except to the extent that expected loss is offset by reserves. The institution will also be allowed to recognize the effect of risk dependency and, to a limited extent, the effect of insurance as a risk mitigant, subject to certain criteria with regard to insurance company strength and policy terms.

The operational risk exposure is converted to an equivalent amount of risk-weighted assets for the calculation of an institution's risk-based capital by multiplying the exposure by 12.5. There is no specific capital floor for operational risk; rather there is an overall floor for both credit and operational risks.

<u>Qualitative Framework/Elements</u>

Institutions will be expected to establish a risk management framework that encompasses all aspects of identifying, measuring, monitoring, and controlling operational risk. As a result, the board of directors must be actively involved in the development and oversight of the operational risk framework. Additionally, the framework must be closely integrated into each business lines day-to-day risk management process. While no specific management structure is mandated, the following three components must be evident:

- Firm-wide Operational Risk Management Function
- Line of Business Oversight
- Independent Testing and Verification Function

Conclusion: We recommend that the Board authorize publication of the attached Guidance and request public comment in the Federal Register.

Attachment

Concur: ____

John M. Brennan
Deputy to the Chairman