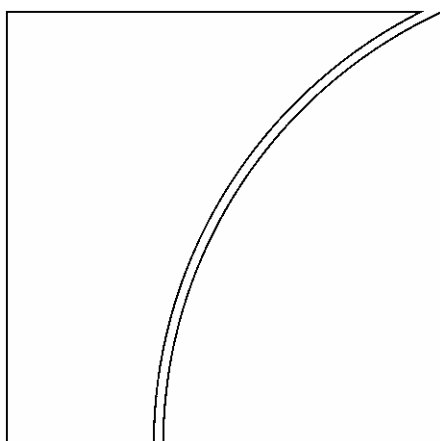


Basel Committee on Banking Supervision



Principles for the home- host recognition of AMA operational risk capital

January 2004



BANK FOR INTERNATIONAL SETTLEMENTS

Table of contents

Principle 1: The calculation of AMA capital requirements should be consistent with the scope of application of the New Accord and the Committee's recent paper on "High-level principles for the cross-border implementation of the New Accord"	1
Principle 2: The board of directors and senior management at each level of a banking organisation have an obligation to understand the operational risk profile at that level of the organisation and ensure that risks are managed appropriately and that the capital held at each level in respect of those risks is adequate.	2
Principle 3: Since experience has shown that capital is generally not freely transferable within a banking group, especially during times of stress, each banking subsidiary within the group must be adequately capitalised on a stand-alone basis.	2
Principle 4: Where possible, supervisors should balance the principles above with the goal of minimising the burden and cost - for both banking organisations and supervisors - of implementing the AMA on a cross-border basis.	3
Attachment	4

Principles for the home-host recognition of AMA operational risk capital

1. The Basel Committee is pursuing an approach to operational risk capital allocation that addresses concerns expressed by a number of organisations in their comments on CP3 about practical impediments to the cross-border implementation of an Advanced Measurement Approach (AMA) for operational risk. The approach sets out how a banking organisation that calculates a group-wide AMA capital requirement might calculate the operational risk capital requirements of its subsidiaries.

2. While the Committee has acknowledged the need for flexibility in implementing the Accord, it is also concerned that such flexibility not undermine the Accord's fundamental objective of ensuring banks are adequately capitalised. Accordingly, the Committee is pursuing a "hybrid" approach for AMA banks under which a banking group would be permitted – subject to supervisory approval – to use a combination of stand-alone AMA calculations for significant internationally active banking subsidiaries and an allocated portion of the group-wide AMA capital requirement for its other internationally active banking subsidiaries. Under this hybrid approach, a significant internationally active banking subsidiary wishing to implement an AMA and able to meet the qualifying criteria would have to calculate its AMA capital requirements on a stand-alone basis. In calculating stand-alone AMA capital requirements, significant internationally active banking subsidiaries may incorporate a well-reasoned estimate of diversification benefits of its own operations, but may not consider group-wide diversification benefits. Where such subsidiaries are part of a group that wishes to implement an AMA on a group-wide basis, they would be permitted to utilise the resources of their parent or other appropriate entities within the group; they could rely on data and parameters calculated at the group level, for example, provided that those variables were adjusted as necessary to be consistent with the subsidiary's operations. Other internationally active subsidiaries that are not determined to be significant in the context of the overall group would be permitted – subject to supervisory approval – to use as their Pillar 1 charge for operational risk an amount that has been allocated to them from the group-wide AMA calculation.

3. The Basel Committee believes the following principles will be useful to guide supervisors on the implementation of this hybrid approach to the allocation of operational risk capital across home and host jurisdictions. The Committee's Accord Implementation Group (AIG) developed these principles in close coordination with the Committee's Risk Management Group.

4. The principles that follow are intended to be broadly compatible with the rules laid out in the Third Consultative Document. However, it is clear that specific enabling language will have to be introduced to the Accord to permit the hybrid approach within Pillar 1. To that end, the Committee is considering the text provided as an attachment to this paper.

Principle 1: The calculation of AMA capital requirements should be consistent with the scope of application of the New Accord and the Committee's recent paper on "High-level principles for the cross-border implementation of the New Accord".¹

5. The New Accord is intended to apply not only to the parent entity of a banking group, but also to all internationally active banks on a consolidated basis at every tier within the banking group. Therefore, under the scope of application, it is required that each internationally active bank would calculate its own capital requirements. At national discretion, supervisors may elect to apply the requirements of the New Accord to domestic banking organisations as well.

6. Likewise, as the cross-border implementation paper (and the Basel Concordat)² makes clear, banking organisations are required not only to meet the requirements of home country supervisors on a consolidated basis, but also to satisfy any requirements established by host country supervisors. Consequently, in cases where an allocation mechanism is permitted under Pillar 1, it will need the approval of both home and host country supervisors. As suggested in the cross-border implementation paper, cooperation between home and host supervisors is encouraged to minimise duplication in review and approval processes. However, even where such cooperative approval may be obtained, host country supervisors would retain the right to impose additional capital requirements under Pillar 2 if they were not satisfied that the capital determined for the subsidiary in their jurisdiction was commensurate with its operational risk profile.

7. Consistent with Principle 6 of the cross-border implementation paper, it will be desirable for home supervisors, in cooperation with relevant host supervisors, to develop a plan well in advance of implementation detailing their respective roles in reviewing and approving the AMA of a bank with significant cross-border operations, and to communicate that plan to the affected banking group with as much lead time as possible. The home supervisor will be responsible for leading this coordination effort, in cooperation with relevant host supervisors, which also could extend to the ongoing monitoring of the bank's AMA. Therefore, it will be incumbent upon the banking group to develop and submit its implementation plan early in the process.

Principle 2: The board of directors and senior management at each level of a banking organisation have an obligation to understand the operational risk profile at that level of the organisation and ensure that risks are managed appropriately and that the capital held at each level in respect of those risks is adequate.

8. One of the fundamental tenets of sound corporate governance is that the primary responsibility for a banking organisation's overall risk management rests with that organisation's board of directors and senior management. Even in instances where a bank may be a wholly-owned subsidiary of a larger banking organisation, the board and senior management of that subsidiary bank are responsible for conducting their own assessment of the bank's risks and operational controls and must ensure that the subsidiary is adequately capitalised for the risks faced by that institution.

¹ *High-level principles for the cross-border implementation of the New Accord*, August 2003 (available on the BIS website at <http://www.bis.org/publ/bcbs100.htm>).

² *Principles for the supervision of banks' foreign establishments*, May 1983 (available on the BIS website at <http://www.bis.org/publ/bcbsc312.pdf>), supplemented by *Information flows between banking supervisory authorities*, April 1990 (available on the BIS website at <http://www.bis.org/publ/bcbsc313.pdf>).

Principle 3: Since experience has shown that capital is generally not freely transferable within a banking group, especially during times of stress, each banking subsidiary within the group must be adequately capitalised on a stand-alone basis.

9. When calculating their AMA capital requirements, banking groups meeting the prescribed conditions for such treatment are allowed to recognise the benefits of group-wide diversification at group level (i.e., while there is a risk of sizeable operational losses in each subsidiary or business line, there is a low likelihood that such losses will occur simultaneously across subsidiaries or business lines). If capital were freely transferable, then in principle each subsidiary could share in the group-wide diversification benefit (since losses in one subsidiary would presumably be covered by other parts of the banking group). However, experience has shown that there are typically a number of legal and practical impediments to the free flow of capital in a banking group, particularly across national boundaries and during stress scenarios. As a result, since a banking subsidiary cannot always rely on assistance from the group in the event of a sizeable operational loss, the benefits of diversification at the overall group level must be excluded for significant banking subsidiaries and may be limited—at the discretion of host supervisors—for non-significant banking subsidiaries. Where an allocation methodology is permitted under Pillar 1, a subsidiary bank’s board, senior management, and supervisors must reasonably consider the impact of group-wide diversification benefits in assessing whether the subsidiary holds an appropriate level of minimum regulatory capital.

Principle 4: Where possible, supervisors should balance the principles above with the goal of minimising the burden and cost - for both banking organisations and supervisors - of implementing the AMA on a cross-border basis.

10. The industry has been clear in its view that requiring calculation of AMA requirements at each legal entity would be unduly burdensome from the standpoint of having to make numerous separate calculations and may not be feasible given data constraints in the case of small- and medium-sized subsidiaries. Likewise, industry commenters have expressed concern that it would be costly and burdensome to maintain the systems infrastructure for separate loss databases in multiple jurisdictions.

11. One way to address industry concerns regarding cost and burden is to allow institutions to leverage group resources at the subsidiary level. So, for example, rather than having quantitative experts and systems in each subsidiary, a banking group could concentrate its quantitative expertise in the parent company or some other appropriate entity within the group to perform calculations on behalf of subsidiaries. Likewise, it would be possible, in calculating AMA capital requirements, for subsidiaries to rely on data and parameters estimated at the parent level, adjusted as necessary for the circumstances of the legal entity. The legal entity’s board of directors and senior management - and host supervisor - would have to have sufficient knowledge about the estimation techniques and assumptions to make an informed decision about the appropriateness of the capital calculation for the legal entity.

12. To be in a position to make such informed decisions, a host supervisor would have to be satisfied with its arrangements with the parent bank and the home supervisor. In particular, early cooperation between home and host supervisors will be critical to ensuring a host supervisor has sufficient time to plan for, review and comment on the group-wide AMA methodology. Where host supervisors wish to adjust the results of the bank’s proposed approach, they will give preference to simple ways of making such adjustments in order to minimise implementation costs for banks.

Attachment

The Committee is considering to include the following enabling language in the Operational Risk section of the New Accord to clarify the allocation of AMA capital according to the principles set out in this paper:

619. Banks adopting the AMA may, with the approval of their relevant host supervisors, use an approved allocation mechanism for the purpose of determining the regulatory capital requirement for internationally active banking subsidiaries that are not deemed to be significant relative to the overall banking group but are themselves subject to the Accord in accordance with the Scope of Application. Supervisory approval of the allocation mechanism is required. Such approval would be conditional on the bank demonstrating to the satisfaction of the home and relevant host supervisors that the allocation mechanism for these subsidiaries is appropriate and can be supported. The board of directors and senior management of each internationally active banking subsidiary are responsible for conducting their own assessment of the subsidiary's operational risks and controls and ensuring the subsidiary is adequately capitalised in respect of those risks.
620. The incorporation of a well-reasoned estimate of diversification benefits – by banks meeting the prescribed criteria for such treatment – may be factored in at the group-wide level or at the banking subsidiary level. However, banking subsidiaries whose host supervisors determine that they must calculate stand-alone capital requirements (see Scope of Application, paragraph XX) may not incorporate group-wide diversification benefits in their AMA calculations (i.e., where an internationally active banking subsidiary is deemed to be significant, the banking subsidiary may incorporate the diversification benefits of its own operations – those arising at the sub-consolidated level – but may not incorporate the diversification benefits of the group).
621. The appropriateness of the allocation methodology will be reviewed with consideration given to the stage of development of risk-sensitive allocation techniques and the extent to which it reflects the level of operational risk in the legal entities and across the banking group. Supervisors expect that AMA banking groups will continue efforts to develop increasingly risk-sensitive operational risk allocation techniques.