Basel Committee on Banking Supervision

OPE
Calculation of RWA for operational risk

This standard describes how to calculate capital requirements for operational risk.
OPE10
Definitions and application

This chapter defines operational risk and introduces the methodologies available for calculating operational risk capital requirements.

Version effective as of 15 Dec 2019

First version in the format of the consolidated framework.
Introduction

10.1 Operational risk is defined as the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. This definition includes legal risk, but excludes strategic and reputational risk.

Footnotes

1 Legal risk includes, but is not limited to, exposure to fines, penalties, or punitive damages resulting from supervisory actions, as well as private settlements.

10.2 The framework outlined in this standard presents three methods for calculating operational risk capital requirements in a continuum of increasing sophistication and risk sensitivity:

(1) the Basic Indicator Approach;

(2) the Standardised Approach; and

(3) Advanced Measurement Approaches (AMAs).

10.3 Banks are encouraged to move along the spectrum of available approaches as they develop more sophisticated operational risk measurement systems and practices. Qualifying criteria for the Standardised Approach and AMA are presented below.

10.4 Internationally active banks and banks with significant operational risk exposures (for example, specialised processing banks) are expected to use an approach that is more sophisticated than the Basic Indicator Approach and that is appropriate for the risk profile of the institution. A bank will be permitted to use the Basic Indicator or Standardised Approach for some parts of its operations and an AMA for others provided certain minimum criteria are met; see OPE10.6 to OPE10.9.

Footnotes

2 Supervisors will review the capital requirement produced by the operational risk approach used by a bank (whether Basic Indicator Approach, Standardised Approach or AMA) for general credibility, especially in relation to a firm’s peers. In the event that credibility is lacking, appropriate supervisory action under Pillar 2 will be considered.
10.5

A bank will not be allowed to choose to revert to a simpler approach once it has been approved for a more advanced approach without supervisory approval. However, if a supervisor determines that a bank using a more advanced approach no longer meets the qualifying criteria for this approach, it may require the bank to revert to a simpler approach for some or all of its operations, until it meets the conditions specified by the supervisor for returning to a more advanced approach.

Partial use

10.6 A bank will be permitted to use an AMA for some parts of its operations and the Basic Indicator Approach or Standardised Approach for the balance (partial use), provided that the following conditions are met:

(1) All operational risks of the bank’s global, consolidated operations are captured;

(2) All of the bank’s operations that are covered by the AMA meet the qualitative criteria for using an AMA, while those parts of its operations that are using one of the simpler approaches meet the qualifying criteria for that approach;

(3) On the date of implementation of an AMA, a significant part of the bank’s operational risks are captured by the AMA; and

(4) The bank provides its supervisor with a plan specifying the timetable to which it intends to roll out the AMA across all but an immaterial part of its operations. The plan should be driven by the practicality and feasibility of moving to the AMA over time, and not for other reasons.

10.7 Subject to the approval of its supervisor, a bank opting for partial use may determine which parts of its operations will use an AMA on the basis of business line, legal structure, geography, or other internally determined basis.

10.8 Subject to the approval of its supervisor, where a bank intends to implement an approach other than the AMA on a global, consolidated basis and it does not meet the third and/or fourth conditions in OPE10.6, the bank may, in limited circumstances:

(1) Implement an AMA on a permanent partial basis; and

(2) Include in its global, consolidated operational risk capital requirements the results of an AMA calculation at a subsidiary where the AMA has been approved by the relevant host supervisor and is acceptable to the bank’s home supervisor.
10.9 Approvals of the nature described in OPE10.8 should be granted only on an exceptional basis. Such exceptional approvals should generally be limited to circumstances where a bank is prevented from meeting these conditions due to implementation decisions of supervisors of the bank’s subsidiary operations in foreign jurisdictions.
OPE20

Basic indicator approach

This chapter describes the Basic Indicator Approach for calculating operational risk capital requirements. This is the simplest of the three approaches.

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First version in the format of the consolidated framework.
20.1 Banks using the Basic Indicator Approach must hold capital for operational risk equal to the average over the previous three years of a fixed percentage (denoted alpha) of positive annual gross income. Figures for any year in which annual gross income is negative or zero should be excluded from both the numerator and denominator when calculating the average. \footnote{If negative gross income distorts a bank’s Pillar 1 capital charge, supervisors will consider appropriate supervisory action under Pillar 2.}

Footnotes
\footnote{If negative gross income distorts a bank’s Pillar 1 capital charge, supervisors will consider appropriate supervisory action under Pillar 2.}

20.2 The capital requirement under the Basic Indicator Approach, $K_{\text{BIA}}$, may be expressed as follows, where GI is annual gross income, where positive, over the previous three years; $n$ is the number of the previous three years for which gross income is positive; and $\alpha$ is 15% (set by the Committee, relating the industry-wide level of required capital to the industry-wide level of the indicator).

$$K_{\text{BIA}} = \frac{\sum (GI_{1-n} \times \alpha)}{n}$$

20.3 Gross income is defined as net interest income plus net non-interest income.\footnote{Gross income is defined as net interest income plus net non-interest income.} It is intended that this measure should:

1. be gross of any provisions (e.g., for unpaid interest);
2. be gross of operating expenses, including fees paid to outsourcing service providers;\footnote{be gross of operating expenses, including fees paid to outsourcing service providers;}
3. exclude realised profits/losses from the sale of securities in the banking book;\footnote{exclude realised profits/losses from the sale of securities in the banking book; and}
4. exclude extraordinary or irregular items as well as income derived from insurance.
Footnotes

2 As defined by national supervisors and/or national accounting standards.

3 In contrast to fees paid for services that are outsourced, fees received by banks that provide outsourcing services shall be included in the definition of gross income.

4 Realised profits/losses from securities classified as “held to maturity” and “available for sale”, which typically constitute items of the banking book (eg under certain accounting standards), are also excluded from the definition of gross income.

20.4 As a point of entry for capital calculation, no specific criteria for use of the Basic Indicator Approach are set out in this Framework. Nevertheless, banks using this approach are encouraged to comply with the Committee’s guidance on Principles for the Sound Management of Operational Risk, June 2011.

20.5 The risk-weighted assets for operational risk under the Basic Indicator Approach are determined by multiplying the capital requirements calculated as set out in this chapter by 12.5.
OPE25

Standardised approach

This chapter sets out two standardised approaches (the Standardised Approach and the Alternative Standardised Approach) for calculating operational risk capital requirements, based on a division of a bank’s activities into eight business lines.

Version effective as of 15 Dec 2019

First version in the format of the consolidated framework.
The Standardised Approach

25.1 In the Standardised Approach, banks’ activities are divided into eight business lines: corporate finance, trading and sales, retail banking, commercial banking, payment and settlement, agency services, asset management, and retail brokerage. The business lines are defined in detail in OPE25.16 to OPE25.25.

25.2 Within each business line, gross income is a broad indicator that serves as a proxy for the scale of business operations and thus the likely scale of operational risk exposure within each of these business lines. The capital requirement for each business line is calculated by multiplying gross income by a factor (denoted beta) assigned to that business line. Beta serves as a proxy for the industry-wide relationship between the operational risk loss experience for a given business line and the aggregate level of gross income for that business line. It should be noted that in the Standardised Approach gross income is measured for each business line, not the whole institution, i.e. in corporate finance, the indicator is the gross income generated in the corporate finance business line.

25.3 The total capital requirement is calculated as the three-year average of the simple summation of the regulatory capital requirements across each of the business lines in each year. In any given year, negative capital requirements (resulting from negative gross income) in any business line may offset positive capital requirements in other business lines without limit.\[1\] However, where the aggregate capital requirement across all business lines within a given year is negative, then the input to the numerator for that year will be zero.\[2\]

Footnotes

1. At national discretion, supervisors may adopt a more conservative treatment of negative gross income.

2. As under the Basic Indicator Approach, if negative gross income distorts a bank’s Pillar 1 capital requirement under the Standardised Approach, supervisors will consider appropriate supervisory action under Pillar 2.

25.4 The total capital requirement under the Standardised Approach, $K_{TSA}$, may be expressed as follows, where $GI_{1-8}$ = annual gross income in a given year, as defined in the Basic Indicator Approach, for each of the eight business lines and $\beta_{1-8}$ = a fixed percentage, set by the Committee, relating the level of required capital to the level of the gross income for each of the eight business lines.
Qualifying criteria for the Standardised Approach

25.5 In order to qualify for use of the Standardised Approach, a bank must satisfy its supervisor that, at a minimum:

(1) Its board of directors and senior management, as appropriate, are actively involved in the oversight of the operational risk management framework;

(2) It has an operational risk management system that is conceptually sound and is implemented with integrity; and

(3) It has sufficient resources in the use of the approach in the major business lines as well as the control and audit areas.

25.6 Supervisors will have the right to insist on a period of initial monitoring of a bank’s Standardised Approach before it is used for regulatory capital purposes.
25.7 A bank must develop specific policies and have documented criteria for mapping gross income for current business lines and activities into the standardised framework. The criteria must be reviewed and adjusted for new or changing business activities as appropriate. The principles for business line mapping are set out in OPE25.16 to OPE25.25.

25.8 As some internationally active banks will wish to use the Standardised Approach, it is important that such banks have adequate operational risk management systems. Consequently, an internationally active bank using the Standardised Approach must meet the following additional criteria:  

(1) The bank must have an operational risk management system with clear responsibilities assigned to an operational risk management function. The operational risk management function is responsible for developing strategies to identify, assess, monitor and control/mitigate operational risk; for codifying firm-level policies and procedures concerning operational risk management and controls; for the design and implementation of the firm’s operational risk assessment methodology; and for the design and implementation of a risk-reporting system for operational risk.

(2) As part of the bank’s internal operational risk assessment system, the bank must systematically track relevant operational risk data including material losses by business line. Its operational risk assessment system must be closely integrated into the risk management processes of the bank. Its output must be an integral part of the process of monitoring and controlling the bank’s operational risk profile. For instance, this information must play a prominent role in risk reporting, management reporting, and risk analysis. The bank must have techniques for creating incentives to improve the management of operational risk throughout the firm.

(3) There must be regular reporting of operational risk exposures, including material operational losses, to business unit management, senior management, and to the board of directors. The bank must have procedures for taking appropriate action according to the information within the management reports.

(4) The bank’s operational risk management system must be well documented. The bank must have a routine in place for ensuring compliance with a documented set of internal policies, controls and procedures concerning the operational risk management system, which must include policies for the treatment of non-compliance issues.
(5) The bank’s operational risk management processes and assessment system must be subject to validation and regular independent review. These reviews must include both the activities of the business units and of the operational risk management function.

(6) The bank’s operational risk assessment system (including the internal validation processes) must be subject to regular independent review by internal or external auditors and/or supervisors.

Footnotes

2 For other banks, these criteria are recommended, with national discretion to impose them as requirements.

The alternative standardised approach

25.9 At national supervisory discretion a supervisor can choose to allow a bank to use the Alternative Standardised Approach (ASA) provided the bank is able to satisfy its supervisor that this alternative approach provides an improved basis by, for example, avoiding double counting of risks. Once a bank has been allowed to use the ASA, it will not be allowed to revert to use of the Standardised Approach without the permission of its supervisor. It is not envisaged that large diversified banks in major markets would use the ASA.

25.10 Supervisors allowing banks to use the ASA must decide on the appropriate qualifying criteria for that approach, as the criteria set forth in OPE25.7 and OPE25.8 may not be appropriate.

25.11 Under the ASA, the operational risk capital requirement/methodology is the same as for the Standardised Approach except for two business lines — retail banking and commercial banking. For these business lines, loans and advances — multiplied by a fixed factor “m” — replaces gross income as the exposure indicator. The betas for retail and commercial banking are unchanged from the Standardised Approach.
25.12 The ASA operational risk capital requirement, $K_{RB}$, for retail banking (with the same basic formula for commercial banking) can be expressed as follows, where $\beta_{RB}$ is the beta for the retail banking business line, $LA_{RB}$ is total outstanding retail loans and advances (non-risk weighted and gross of provisions), averaged over the past three years, and $m$ is $0.035$:

$$K_{RB} = \beta_{RB} \times m \times LA_{RB}$$

25.13 For the purposes of the ASA, total loans and advances in the retail banking business line consists of the total drawn amounts in the following credit portfolios: retail, small or medium-sized entities (SMEs) treated as retail, and purchased retail receivables. For commercial banking, total loans and advances consists of the drawn amounts in the following credit portfolios: corporate, sovereign, bank, specialised lending, SMEs treated as corporate and purchased corporate receivables. The book value of securities held in the banking book should also be included.

25.14 Under the ASA, banks may aggregate retail and commercial banking (if they wish to) using a beta of 15%. Similarly, those banks that are unable to disaggregate their gross income into the other six business lines can aggregate the total gross income for these six business lines using a beta of 18%, with negative gross income treated as described in OPE25.3 and OPE25.4.

25.15 As under the Standardised Approach, the total capital requirement for the ASA is calculated as the simple summation of the regulatory capital requirements across each of the eight business lines.

**Business lines**

25.16 All activities must be mapped into the eight level 1 business lines in Table 2 in a mutually exclusive and jointly exhaustive manner.
<table>
<thead>
<tr>
<th>Level 1</th>
<th>Level 2</th>
<th>Activity groups</th>
</tr>
</thead>
<tbody>
<tr>
<td>Corporate finance</td>
<td>Corporate finance</td>
<td>Mergers and acquisitions, underwriting, privatisations, securitisation, research, debt (government, high yield), equity, syndications, initial public offerings, secondary private placements</td>
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<tr>
<td></td>
<td>Municipal / government finance</td>
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<td></td>
<td>Merchant banking</td>
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<td></td>
<td>Advisory services</td>
<td></td>
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<tr>
<td>Trading and sales</td>
<td>Sales</td>
<td>Fixed income, equity, foreign exchanges, commodities, credit, funding, own position securities, lending and repos, brokerage, debt, prime brokerage</td>
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<td></td>
<td>Market-making</td>
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<td></td>
<td>Proprietary positions</td>
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<tr>
<td></td>
<td>Treasury</td>
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<tr>
<td>Retail banking</td>
<td>Retail banking</td>
<td>Retail lending and deposits, banking services, trust and estates</td>
</tr>
<tr>
<td></td>
<td>Private banking</td>
<td>Private lending and deposits, banking services, trust and estates, investment advice</td>
</tr>
<tr>
<td></td>
<td>Card services</td>
<td>Merchant / commercial / corporate cards, private labels and retail</td>
</tr>
<tr>
<td>Commercial banking</td>
<td>Commercial banking</td>
<td>Project finance, real estate, export finance, trade finance, factoring, leasing, lending, guarantees, bills of exchange</td>
</tr>
<tr>
<td>Payment and settlement</td>
<td>External clients</td>
<td>Payments and collections, funds transfer, clearing and settlement</td>
</tr>
<tr>
<td>Agency services</td>
<td>Custody</td>
<td>Escrow, depository receipts, securities lending (customers), corporate actions</td>
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<tr>
<td></td>
<td>Corporate agency</td>
<td>Issuer and paying agents</td>
</tr>
<tr>
<td></td>
<td>Corporate trust</td>
<td></td>
</tr>
<tr>
<td>Asset management</td>
<td>Discretionary fund management</td>
<td>Pooled, segregated, retail, institutional, closed, open, private equity</td>
</tr>
</tbody>
</table>
Non-discretionary fund management | Pooled, segregated, retail, institutional, closed, open
---|---
Retail brokerage | Retail brokerage | Execution and full service

Footnotes

4 Payment and settlement losses related to a bank’s own activities would be incorporated in the loss experience of the affected business line.

25.17 Any banking or non-banking activity which cannot be readily mapped into the business line framework, but which represents an ancillary function to an activity included in the framework, must be allocated to the business line it supports. If more than one business line is supported through the ancillary activity, an objective mapping criteria must be used.

25.18 When mapping gross income, if an activity cannot be mapped into a particular business line then the business line yielding the highest requirement must be used. The same business line equally applies to any associated ancillary activity.

25.19 Banks may use internal pricing methods to allocate gross income between business lines provided that total gross income for the bank (as would be recorded under the Basic Indicator Approach) still equals the sum of gross income for the eight business lines.

25.20 The mapping of activities into business lines for operational risk capital purposes must be consistent with the definitions of business lines used for regulatory capital calculations in other risk categories, ie credit and market risk. Any deviations from this principle must be clearly motivated and documented.

25.21 The mapping process used must be clearly documented. In particular, written business line definitions must be clear and detailed enough to allow third parties to replicate the business line mapping. Documentation must, among other things, clearly motivate any exceptions or overrides and be kept on record.

25.22 Processes must be in place to define the mapping of any new activities or products.

25.23 Senior management is responsible for the mapping policy (which is subject to the approval by the board of directors).

25.24 The mapping process to business lines must be subject to independent review.
25.25 There are a variety of valid approaches that banks can use to map their activities to the eight business lines, provided the approach used meets the business line mapping principles. Nevertheless, the Committee is aware that some banks would welcome further guidance. The following is therefore an example of one possible approach that could be used by a bank to map its gross income:

(1) Gross income for retail banking consists of net interest income on loans and advances to retail customers and SMEs treated as retail, plus fees related to traditional retail activities, net income from swaps and derivatives held to hedge the retail banking book, and income on purchased retail receivables. To calculate net interest income for retail banking, a bank takes the interest earned on its loans and advances to retail customers less the weighted average cost of funding of the loans (from whatever source retail or other deposits).

(2) Similarly, gross income for commercial banking consists of the net interest income on loans and advances to corporate (plus SMEs treated as corporate), interbank and sovereign customers and income on purchased corporate receivables, plus fees related to traditional commercial banking activities including commitments, guarantees, bills of exchange, net income (eg from coupons and dividends) on securities held in the banking book, and profits/losses on swaps and derivatives held to hedge the commercial banking book. Again, the calculation of net interest income is based on interest earned on loans and advances to corporate, interbank and sovereign customers less the weighted average cost of funding for these loans (from whatever source).

(3) For trading and sales, gross income consists of profits/losses on instruments held for trading purposes (ie in the mark-to-market book), net of funding cost, plus fees from wholesale broking.

(4) For the other five business lines, gross income consists primarily of the net fees/commissions earned in each of these businesses. Payment and settlement consists of fees to cover provision of payment/settlement facilities for wholesale counterparties. Asset management is management of assets on behalf of others.

Calculation of risk-weighted assets

25.26 The risk-weighted assets for operational risk under the standardised approaches are determined by multiplying the capital requirements calculated as set out in this chapter by 12.5.
OPE30

Advanced Measurement Approaches

This chapter describes the criteria that banks must meet to be able to calculate operational risk capital requirements based on internal risk measurement systems.

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Introduction

30.1 Under the Advanced Measurement Approaches (AMA), the regulatory capital requirement will equal the risk measure generated by the bank’s internal operational risk measurement system using the quantitative and qualitative criteria for the AMA discussed below. Use of the AMA is subject to supervisory approval.

30.2 A bank adopting the AMA may, with the approval of its host supervisors and the support of its home supervisor, use an 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 this Framework in accordance with SCO10. Supervisory approval would be conditional on the bank demonstrating to the satisfaction of the relevant supervisors that the allocation mechanism for these subsidiaries is appropriate and can be supported empirically. The board of directors and senior management of each 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.

30.3 Subject to supervisory approval as discussed in OPE30.11(4), the incorporation of a well-reasoned estimate of diversification benefits may be factored in at the group-wide level or at the banking subsidiary level. However, any banking subsidiaries whose host supervisors determine that they must calculate stand-alone capital requirements (see SCO10) may not incorporate group-wide diversification benefits in their AMA calculations (eg 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 parent).

30.4 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, notwithstanding initial approval of techniques based on gross income or other proxies for operational risk.

30.5 Banks adopting the AMA will be required to calculate their capital requirement using this approach as well as the 1988 Accord as outlined in RBC20.14.
General standards for using the AMA

30.6 In order to qualify for use of the AMA a bank must satisfy its supervisor that, at a minimum:

(1) Its board of directors and senior management, as appropriate, are actively involved in the oversight of the operational risk management framework;

(2) It has an operational risk management system that is conceptually sound and is implemented with integrity; and

(3) It has sufficient resources in the use of the approach in the major business lines as well as the control and audit areas.

30.7 A bank’s AMA will be subject to a period of initial monitoring by its supervisor before it can be used for regulatory purposes. This period will allow the supervisor to determine whether the approach is credible and appropriate. As discussed below, a bank’s internal measurement system must reasonably estimate unexpected losses based on the combined use of internal and relevant external loss data, scenario analysis and bank-specific business environment and internal control factors. The bank’s measurement system must also be capable of supporting an allocation of economic capital for operational risk across business lines in a manner that creates incentives to improve business line operational risk management.

Qualitative standards for using the AMA

30.8 A bank must meet the following qualitative standards before it is permitted to use an AMA for operational risk capital:

(1) The bank must have an independent operational risk management function that is responsible for the design and implementation of the bank’s operational risk management framework. The operational risk management function is responsible for codifying firm-level policies and procedures concerning operational risk management and controls; for the design and implementation of the firm’s operational risk measurement methodology; for the design and implementation of a risk-reporting system for operational risk; and for developing strategies to identify, measure, monitor and control/mitigate operational risk.
(2) The bank’s internal operational risk measurement system must be closely integrated into the day-to-day risk management processes of the bank. Its output must be an integral part of the process of monitoring and controlling the bank’s operational risk profile. For instance, this information must play a prominent role in risk reporting, management reporting, internal capital allocation, and risk analysis. The bank must have techniques for allocating operational risk capital to major business lines and for creating incentives to improve the management of operational risk throughout the firm.

(3) There must be regular reporting of operational risk exposures and loss experience to business unit management, senior management, and to the board of directors. The bank must have procedures for taking appropriate action according to the information within the management reports.

(4) The bank’s operational risk management system must be well documented. The bank must have a routine in place for ensuring compliance with a documented set of internal policies, controls and procedures concerning the operational risk management system, which must include policies for the treatment of non-compliance issues.

(5) Internal and/or external auditors must perform regular reviews of the operational risk management processes and measurement systems. This review must include both the activities of the business units and of the independent operational risk management function.

(6) The validation of the operational risk measurement system by external auditors and/or supervisory authorities must include the following:

(a) Verifying that the internal validation processes are operating in a satisfactory manner; and

(b) Making sure that data flows and processes associated with the risk measurement system are transparent and accessible. In particular, it is necessary that auditors and supervisory authorities are in a position to have easy access, whenever they judge it necessary and under appropriate procedures, to the system’s specifications and parameters.
Quantitative standards for using the AMA

30.9 Given the continuing evolution of analytical approaches for operational risk, the Committee is not specifying the approach or distributional assumptions used to generate the operational risk measure for regulatory capital purposes. However, a bank must be able to demonstrate that its approach captures potentially severe “tail” loss events. Whatever approach is used, a bank must demonstrate that its operational risk measure meets a soundness standard comparable to that of the internal ratings-based approach for credit risk (ie comparable to a one year holding period and a 99.9th percentile confidence interval).

30.10 In the development of operational risk measurement and management systems, banks must have and maintain rigorous procedures for operational risk model development and independent model validation.

30.11 The following quantitative standards apply to internally generated operational risk measures for purposes of calculating the regulatory minimum capital requirements.

(1) Any internal operational risk measurement system must be consistent with the scope of operational risk defined in Table 1.

(2) Supervisors will require the bank to calculate its regulatory capital requirement as the sum of expected loss (EL) and unexpected loss (UL), unless the bank can demonstrate that it is adequately capturing EL in its internal business practices. That is, to base the minimum regulatory capital requirement on UL alone, the bank must be able to demonstrate to the satisfaction of its national supervisor that it has measured and accounted for its EL exposure.

(3) A bank’s risk measurement system must be sufficiently ‘granular’ to capture the major drivers of operational risk affecting the shape of the tail of the loss estimates.
(4) Risk measures for different operational risk estimates must be added for purposes of calculating the regulatory minimum capital requirement. However, the bank may be permitted to use internally determined correlations in operational risk losses across individual operational risk estimates, provided it can demonstrate to the satisfaction of the national supervisor that its systems for determining correlations are sound, implemented with integrity, and take into account the uncertainty surrounding any such correlation estimates (particularly in periods of stress). The bank must validate its correlation assumptions using appropriate quantitative and qualitative techniques.

(5) Any operational risk measurement system must have certain key features to meet the supervisory soundness standard set out in this section. These elements must include the use of internal data, relevant external data, scenario analysis and factors reflecting the business environment and internal control systems.
A bank needs to have a credible, transparent, well-documented and verifiable approach for weighting these fundamental elements in its overall operational risk measurement system. For example, there may be cases where estimates of the 99.9th percentile confidence interval based primarily on internal and external loss event data would be unreliable for business lines with a heavy-tailed loss distribution and a small number of observed losses. In such cases, scenario analysis, and business environment and control factors, may play a more dominant role in the risk measurement system. Conversely, operational loss event data may play a more dominant role in the risk measurement system for business lines where estimates of the 99.9th percentile confidence interval based primarily on such data are deemed reliable. In all cases, the bank’s approach for weighting the four fundamental elements should be internally consistent and avoid the double counting of qualitative assessments or risk mitigants already recognised in other elements of the framework.

### Detailed loss event type classification

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<th>Event-type category (Level 1)</th>
<th>Definition</th>
<th>Categories (Level 2)</th>
<th>Activity examples (Level 3)</th>
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<tr>
<td>Internal fraud</td>
<td>Losses due to acts of a type intended to defraud, misappropriate property or circumvent regulations, the law or company policy, excluding diversity/discrimination events, which involves at least one internal party</td>
<td>Unauthorised activity</td>
<td>Transactions not reported (intentional)</td>
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<td></td>
<td></td>
<td>Mismarking of position (intentional)</td>
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<td>Theft and fraud</td>
<td>Fraud / credit fraud / worthless deposits</td>
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<td>Theft / extortion / embezzlement / robbery</td>
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<td>Misappropriation of assets</td>
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<td>Malicious destruction of assets</td>
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<td>Check kiting</td>
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<td></td>
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<td></td>
<td>Smuggling</td>
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<tr>
<td><strong>External fraud</strong></td>
<td><strong>Losses due to acts of a type intended to defraud, misappropriate property or circumvent the law, by a third party</strong></td>
<td><strong>Theft and fraud</strong></td>
<td><strong>Theft / robbery</strong></td>
</tr>
</tbody>
</table>

**Account takeover / impersonation etc**

**Tax non-compliance / evasion (wilful)**

**Bribes / kickbacks**

**Insider trading (not on firm’s account)**

|**Employment practices and workplace safety** |**Losses arising from acts inconsistent with employment, health or safety laws or agreements, from payment of personal injury claims, or from diversity / discrimination events** |**Employee relations** |**Compensation, benefit, termination issues** |

**Organised labour activity**

|**Safe environment** |**General liability (slip and fall etc)** |

**Employee health and safety rules events**

**Workers compensation**

|**Diversity and discrimination** |**All discrimination types** |

|**Clients, products and business practices** |**Losses arising from an unintentional or negligent failure to meet a professional obligation to specific clients (including fiduciary and suitability requirements), or** |**Suitability, disclosure and fiduciary** |**Fiduciary breaches / guideline violations** |

**Suitability / disclosure issues (know-your-customer etc)**

**Retail customer disclosure violations**

**Breach of privacy**

**Aggressive sales**

**Account churning**
<table>
<thead>
<tr>
<th>Category</th>
<th>Examples</th>
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<tr>
<td>Misuse of confidential information</td>
<td>Lender liability</td>
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<td>Improper business or market practices</td>
<td>Antitrust</td>
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<tr>
<td></td>
<td>Improper trade / market practices</td>
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<td></td>
<td>Market manipulation</td>
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<td></td>
<td>Insider trading (on firm’s account)</td>
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<td></td>
<td>Unlicensed activity</td>
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<td></td>
<td>Money laundering</td>
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<tr>
<td>Product flaws</td>
<td>Product defects (unauthorised etc)</td>
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<td></td>
<td>Model errors</td>
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<td>Selection, sponsorship and exposure</td>
<td>Failure to investigate client per guidelines</td>
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<td>Exceeding client exposure limits</td>
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<td>Advisory activities</td>
<td>Disputes over performance of advisory activities</td>
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<td>Losses arising from loss or damage to physical assets from natural disaster or other events</td>
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<td>Disasters and other events</td>
<td>Natural disaster losses</td>
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<td>Business disruption and system failures</td>
<td>Losses arising from disruption of business or system failures</td>
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<td>Utility outage / disruptions</td>
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<td>Execution, delivery and process management</td>
<td>Losses from failed transaction processing or process</td>
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<td>Transaction capture, execution and maintenance</td>
<td>Miscommunication</td>
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<td>Data entry, maintenance or loading error</td>
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<td>Category</td>
<td>Root Cause</td>
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<td>---------------------------------------------------------------------------</td>
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<tr>
<td>management, from relations with trade counterparties and vendors</td>
<td>Missed deadline or responsibility</td>
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<td></td>
<td>Model / system misoperation</td>
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<td>Accounting error / entity attribution error</td>
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<td>Other task misperformance</td>
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<td>Delivery failure</td>
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<td>Monitoring and reporting</td>
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<td>Inaccurate external report (loss incurred)</td>
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<td>Customer intake and documentation</td>
<td>Client permissions / disclaimers missing</td>
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<td>Vendor disputes</td>
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</table>
30.12 Banks must track internal loss data according to the criteria set out in OPE30.12 to OPE30.15. The tracking of internal loss event data is an essential prerequisite to the development and functioning of a credible operational risk measurement system. Internal loss data is crucial for tying a bank’s risk estimates to its actual loss experience. This can be achieved in a number of ways, including using internal loss data as the foundation of empirical risk estimates, as a means of validating the inputs and outputs of the bank’s risk measurement system, or as the link between loss experience and risk management and control decisions.

30.13 Internal loss data is most relevant when it is clearly linked to a bank’s current business activities, technological processes and risk management procedures. Therefore, a bank must have documented procedures for assessing the on-going relevance of historical loss data, including those situations in which judgement overrides, scaling, or other adjustments may be used, to what extent they may be used and who is authorised to make such decisions.

30.14 Internally generated operational risk measures used for regulatory capital purposes must be based on a minimum five-year observation period of internal loss data, whether the internal loss data is used directly to build the loss measure or to validate it. When the bank first moves to the AMA, a three-year historical data window is acceptable (this includes the parallel calculations in RBC20.14).

30.15 To qualify for regulatory capital purposes, a bank’s internal loss collection processes must meet the following standards:

1. To assist in supervisory validation, a bank must be able to map its historical internal loss data into the relevant level 1 supervisory categories defined in OPE25.16 to OPE25.25 and OPE30.11 and to provide these data to supervisors upon request. It must have documented, objective criteria for allocating losses to the specified business lines and event types. However, it is left to the bank to decide the extent to which it applies these categorisations in its internal operational risk measurement system.

2. A bank’s internal loss data must be comprehensive in that it captures all material activities and exposures from all appropriate sub-systems and geographic locations. A bank must be able to justify that any excluded activities or exposures, both individually and in combination, would not have a material impact on the overall risk estimates. A bank must have an appropriate de minimis gross loss threshold for internal loss data collection, for example €10,000. The appropriate threshold may vary somewhat between banks, and within a bank across business lines and/or event types. However, particular thresholds should be broadly consistent with those used by peer banks.
(3) Aside from information on gross loss amounts, a bank should collect information about the date of the event, any recoveries of gross loss amounts, as well as some descriptive information about the drivers or causes of the loss event. The level of detail of any descriptive information should be commensurate with the size of the gross loss amount.

(4) A bank must develop specific criteria for assigning loss data arising from an event in a centralised function (e.g., an information technology department) or an activity that spans more than one business line, as well as from related events over time.

(5) Operational risk losses that are related to credit risk and have historically been included in banks’ credit risk databases (e.g., collateral management failures) will continue to be treated as credit risk for the purposes of calculating minimum regulatory capital under this Framework. Therefore, such losses will not be subject to the operational risk capital requirements.1 Nevertheless, for the purposes of internal operational risk management, banks must identify all material operational risk losses consistent with the scope of the definition of operational risk (as set out in OPE10.1 and the loss event types outlined in OPE30.11), including those related to credit risk. Such material operational risk-related credit risk losses should be flagged separately within a bank’s internal operational risk database. The materiality of these losses may vary between banks, and within a bank across business lines and/or event types. Materiality thresholds should be broadly consistent with those used by peer banks.

(6) Operational risk losses that are related to market risk are treated as operational risk for the purposes of calculating minimum regulatory capital under this Framework and will therefore be subject to the operational risk capital requirements.

Footnotes
1 This applies to all banks, including those that may only now be designing their credit risk and operational risk databases.
30.16 A bank’s operational risk measurement system must use relevant external data (either public data and/or pooled industry data), especially when there is reason to believe that the bank is exposed to infrequent, yet potentially severe, losses. These external data should include data on actual loss amounts, information on the scale of business operations where the event occurred, information on the causes and circumstances of the loss events, or other information that would help in assessing the relevance of the loss event for other banks. A bank must have a systematic process for determining the situations for which external data must be used and the methodologies used to incorporate the data (e.g., scaling, qualitative adjustments, or informing the development of improved scenario analysis). The conditions and practices for external data use must be regularly reviewed, documented, and subject to periodic independent review.

30.17 A bank must use scenario analysis of expert opinion in conjunction with external data to evaluate its exposure to high-severity events. This approach draws on the knowledge of experienced business managers and risk management experts to derive reasoned assessments of plausible severe losses. For instance, these expert assessments could be expressed as parameters of an assumed statistical loss distribution. In addition, scenario analysis should be used to assess the impact of deviations from the correlation assumptions embedded in the bank’s operational risk measurement framework, in particular, to evaluate potential losses arising from multiple simultaneous operational risk loss events. Over time, such assessments need to be validated and re-assessed through comparison to actual loss experience to ensure their reasonableness.

30.18 In addition to using loss data, whether actual or scenario-based, a bank’s firm-wide risk assessment methodology must capture key business environment and internal control factors that can change its operational risk profile. These factors will make a bank’s risk assessments more forward-looking, more directly reflect the quality of the bank’s control and operating environments, help align capital assessments with risk management objectives, and recognise both improvements and deterioration in operational risk profiles in a more immediate fashion. To qualify for regulatory capital purposes, the use of these factors in a bank’s risk measurement framework must meet the following standards:

(1) The choice of each factor needs to be justified as a meaningful driver of risk, based on experience and involving the expert judgment of the affected business areas. Whenever possible, the factors should be translatable into quantitative measures that lend themselves to verification.
(2) The sensitivity of a bank’s risk estimates to changes in the factors and the relative weighting of the various factors need to be well reasoned. In addition to capturing changes in risk due to improvements in risk controls, the framework must also capture potential increases in risk due to greater complexity of activities or increased business volume.

(3) The framework and each instance of its application, including the supporting rationale for any adjustments to empirical estimates, must be documented and subject to independent review within the bank and by supervisors.

(4) Over time, the process and the outcomes need to be validated through comparison to actual internal loss experience, relevant external data, and appropriate adjustments made.

Risk mitigation

30.19 Under the AMA, a bank will be allowed to recognise the risk mitigating impact of insurance in the measures of operational risk used for regulatory minimum capital requirements. The recognition of insurance mitigation will be limited to 20% of the total operational risk capital requirements calculated under the AMA.

30.20 A bank’s ability to take advantage of such risk mitigation will depend on compliance with the following criteria:

(1) The insurance provider has a minimum claims paying ability rating of A (or equivalent).

(2) The insurance policy must have an initial term of no less than one year. For policies with a residual term of less than one year, the bank must make appropriate haircuts reflecting the declining residual term of the policy, up to a full 100% haircut for policies with a residual term of 90 days or less.

(3) The insurance policy has a minimum notice period for cancellation of 90 days.

(4) The insurance policy has no exclusions or limitations triggered by supervisory actions or, in the case of a failed bank, that preclude the bank, receiver or liquidator from recovering for damages suffered or expenses incurred by the bank, except in respect of events occurring after the initiation of receivership or liquidation proceedings in respect of the bank, provided that the insurance policy may exclude any fine, penalty, or punitive damages resulting from supervisory actions.
(5) The risk mitigation calculations must reflect the bank’s insurance coverage in a manner that is transparent in its relationship to, and consistent with, the actual likelihood and impact of loss used in the bank’s overall determination of its operational risk capital.

(6) The insurance is provided by a third-party entity. In the case of insurance through captives and affiliates, the exposure has to be laid off to an independent third-party entity, for example through re-insurance, that meets the eligibility criteria.

(7) The framework for recognising insurance is well reasoned and documented.

(8) The bank discloses a description of its use of insurance for the purpose of mitigating operational risk.

30.21 A bank’s methodology for recognising insurance under the AMA also needs to capture the following elements through appropriate discounts or haircuts in the amount of insurance recognition:

(1) The residual term of a policy, where less than one year, as noted above;

(2) A policy’s cancellation terms, where less than one year; and

(3) The uncertainty of payment as well as mismatches in coverage of insurance policies.

Calculation of risk-weighted assets

30.22 The risk-weighted assets for operational risk under the AMA are determined by multiplying the capital requirements calculated as set out in this chapter by 12.5.