



BASEL COMMITTEE ON BANKING SUPERVISION

BANK FOR INTERNATIONAL SETTLEMENTS

The Work of the AIG Operational Risk Subgroup (AIGOR)

Financial Stability Institute

Seminar on Practical Techniques for the Management and Measurement of Operational Risk

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Outline

- The who, why and what of the AIGOR
- Op risk implementation issues and range of practice
 - Internal governance
 - Data
 - Modelling (AMA)
- Home-host in an AMA context
- Wrapping up
- Reference materials



AIGOR

Who, Why and What



AIGOR – Who

- Accord Implementation Group (AIG) established by Basel Committee
- AIG currently has 3 subgroups
 - AIG Validation (validation of IRB approaches)
 - AIG Trading Book (implementation of recent revisions to trading book framework)
 - *AIG Operational Risk* (implementation of op risk approaches)
- AIGOR includes five non-Basel member countries



AIGOR – Why

- Consolidated (home) and sub-consolidated (host) capital requirements in accordance with local rules
 - At least 61 national discretion items in Pillar 1, plus Pillar 2 ...
- Basel II is not “one-size-fits-all”
- Requires multiple approvals and is therefore likely to create some new implementation challenges
 - Initial approval and validation
 - Ongoing assessments to verify that banking groups continue to meet qualifying criteria
 - Supervisory review process under Pillar 2

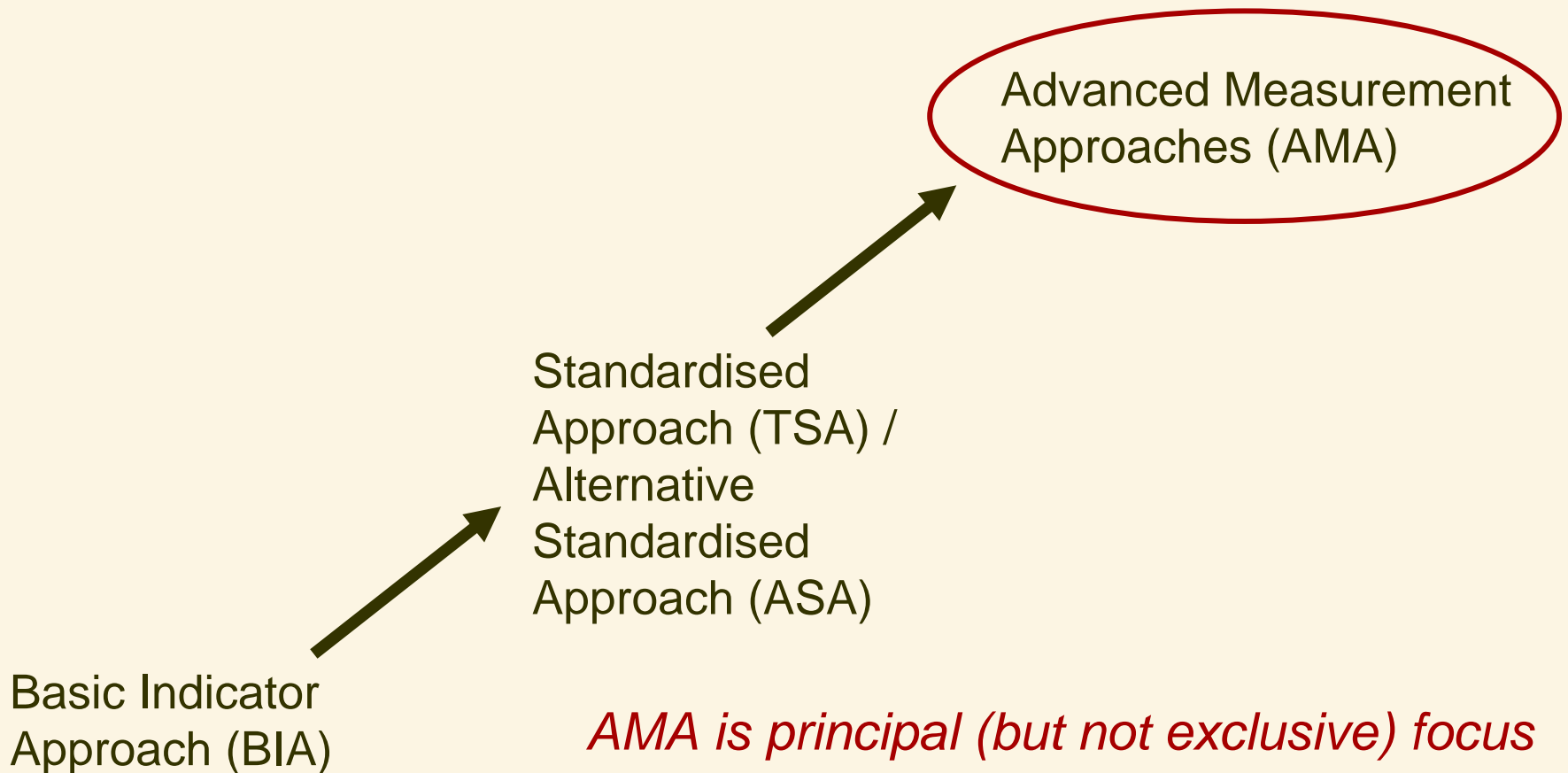


AIGOR – What

- AIGOR mandate:
 - Share information and thereby promote consistency in implementation of Basel II op risk framework
 - Facilitate resolution of related cross-border issues
- AIGOR *is*: forum for discussion and practical way to share experience; collector of information; occasional developer of clarification, elaboration on Basel II
- AIGOR *is not*: creator of new rules; “Basel Control Central”; guarantor of uniformity



AIGOR – What





AIGOR – What

- First meeting December 2004, quarterly since then
- Agendas typically include:
 - Discussion of key implementation issues
 - Members' presentations on domestic implementation
 - Meetings with individual banks, banking associations
- Issues can be grouped under four broad headings:
 - Internal governance
 - Data
 - Modelling
 - Home-host and other



Op risk implementation issues and range of practice



Op risk implementation issues

- Some are unique to op risk, others overlap credit
- Some are unique to simpler or advanced approaches, others overlap
- Gross Income definition and validation / reconciliation
- Mapping to standard 8X7 matrix
 - Gross Income
 - Op risk losses
- Qualifying criteria – TSA vs ASA vs AMA
- Data requirements for TSA banks



Op risk implementation issues and range of practice

Internal Governance



Internal governance issues

- Assessing the level of board involvement
- Expectations of / standards for op risk management “function”
- Relative roles/responsibilities of op risk management function and internal audit
- Meaning of the “use test”
- Senior management / board reporting



Op risk implementation issues and range of practice

Data



Data issues

- Scope of data collection
- Timing of recognition of internal losses
- Allocation of large losses over time and across business lines, event types
- Gross vs net loss amounts
- Boundary with credit, market risk
- Loss collection thresholds
- Validation of internal data



Op risk implementation issues and range of practice

Modelling (AMA)



Modelling issues (AMA)

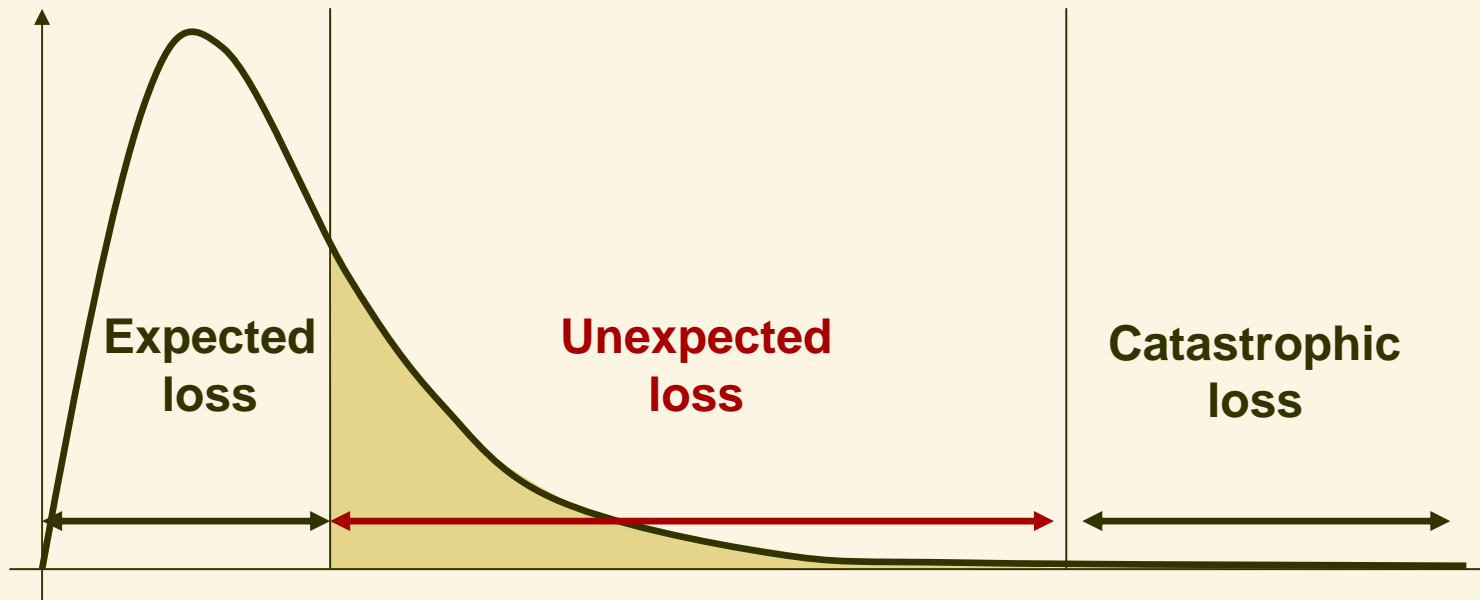
Key points

- Banks meeting rigorous supervisory standards can use internal capital assessment techniques to calculate capital charges – explicit supervisory approval required
- Subject to floors 2007-2009
- Balance between flexibility (industry) and consistency (Basel)
- Risk measurement and management both important
- Qualifying criteria, *but* four required elements (internal data, external data, scenario analysis, business environment & internal control factors)



Modelling issues (AMA)

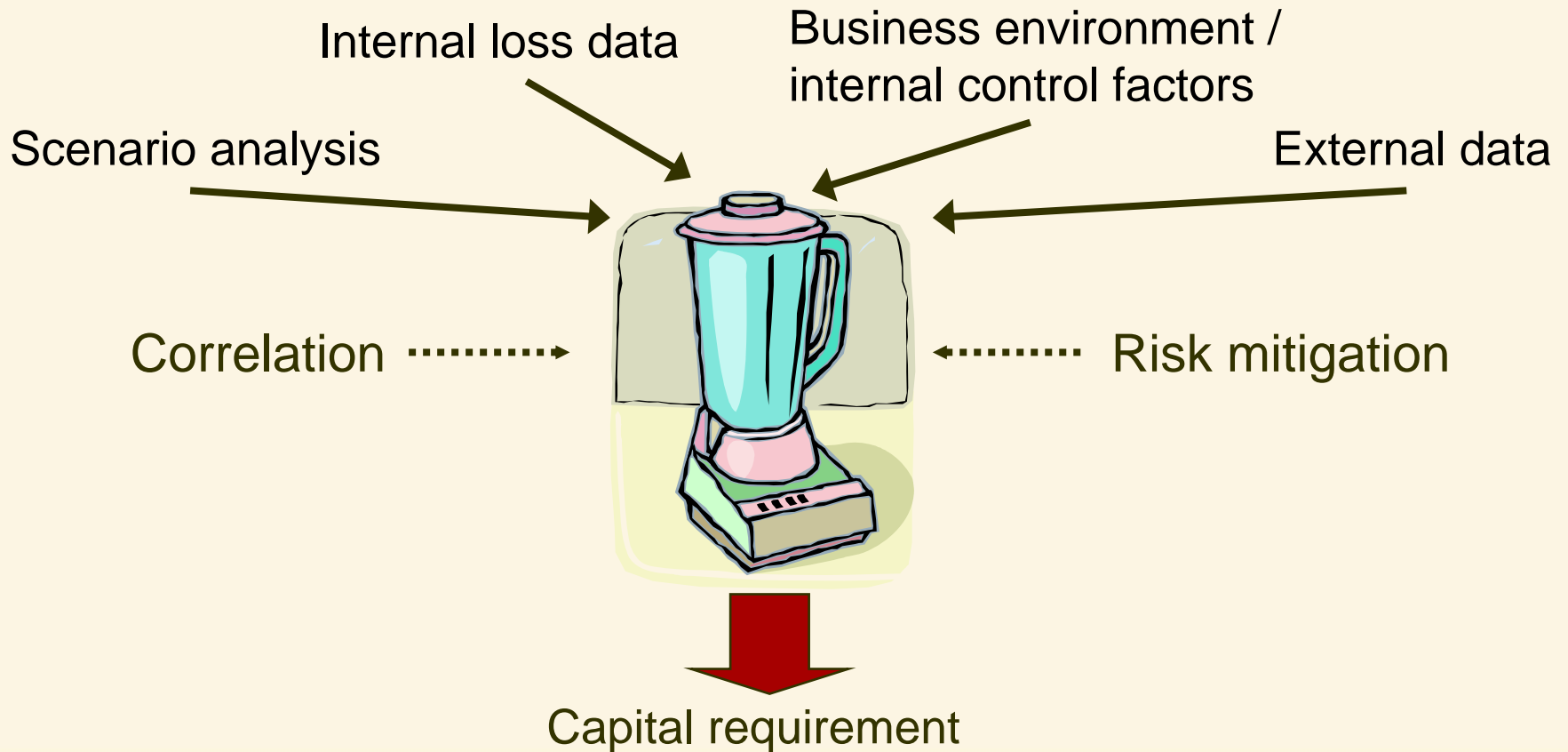
*Frequency
of loss*



Amount of loss



Advanced Measurement Approaches (AMA)





Modelling issues (AMA)

- Range of AMAs are emerging:
 - Loss distribution approach
 - Scenarios-based approach
- What's the difference?
 - Weighting, how / when elements are introduced ...



Modelling issues (AMA)

- Granularity / unit of measure
- Correlations
- Distributional assumptions
- Use of external data, scenario analysis
- Combination of four required elements
- Insurance as a risk mitigant
- Treatment of EL



Home-host in an AMA context



Home-Host issues

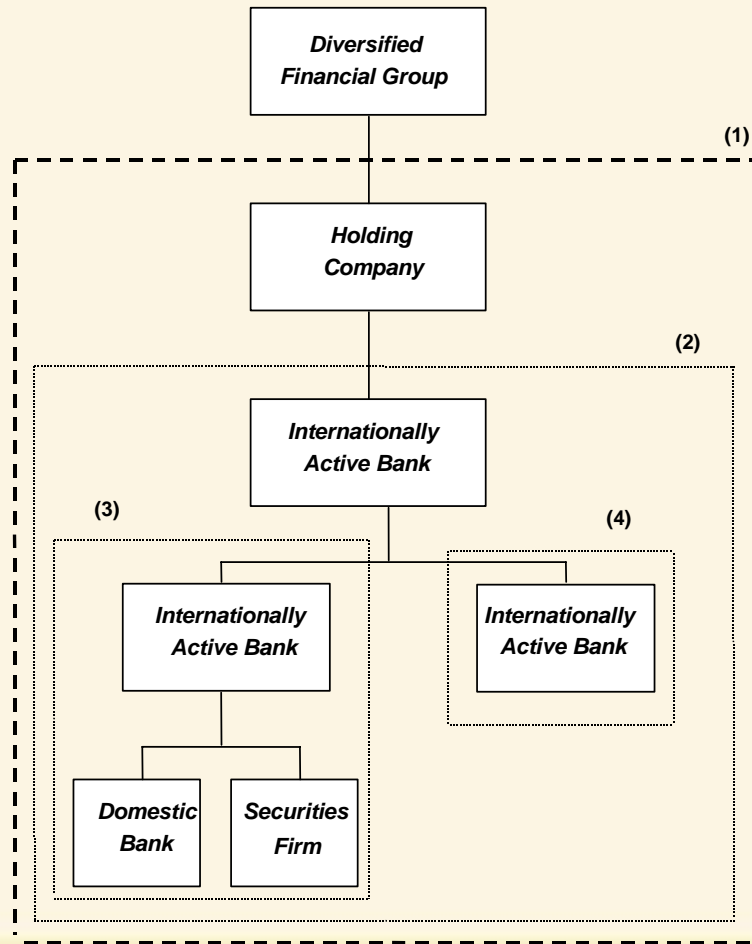
Basel Committee and cross-border supervision

- Basel Committee was specifically created as a forum for supervisors to address issues related to cross-border supervision
- Available resources: Basel Concordat, guidance on supervision of cross-border banking, etc
- Build trust and supervisory network, encourage others (eg regional groups of supervisors) to do so as well

The need for effective cross-border supervision is not new



Scope of application of Basel II





Home-Host issues

- Arrangements for cooperation have a limit – supervision is a sovereign issue
- Consolidated (home) and sub-consolidated (host) capital requirements in accordance with local rules
- Convoluted banking groups, structures
- “Distance risk” – difficult to measure and control activities outside the home environment
- Some bank systems and processes centralised, others more local
- Capital requirements apply to legal entities, but banks manage along business lines (ie across legal entities)



Home-Host issues

- Supervisory methodologies, quantity/quality of supervisory resources, and characteristics of local banking systems vary
- Some supervisors may be reluctant to rely on others
- Examples of practical challenges include:
 - Initial and ongoing supervisory approvals, validation
 - Supervisory review process under Pillar 2
 - Bank-wide info requirements for AMA are substantial
 - Basel II is not “one-size-fits-all” – significant variation is likely across jurisdictions
 - Capital allocation across different business units in a banking group

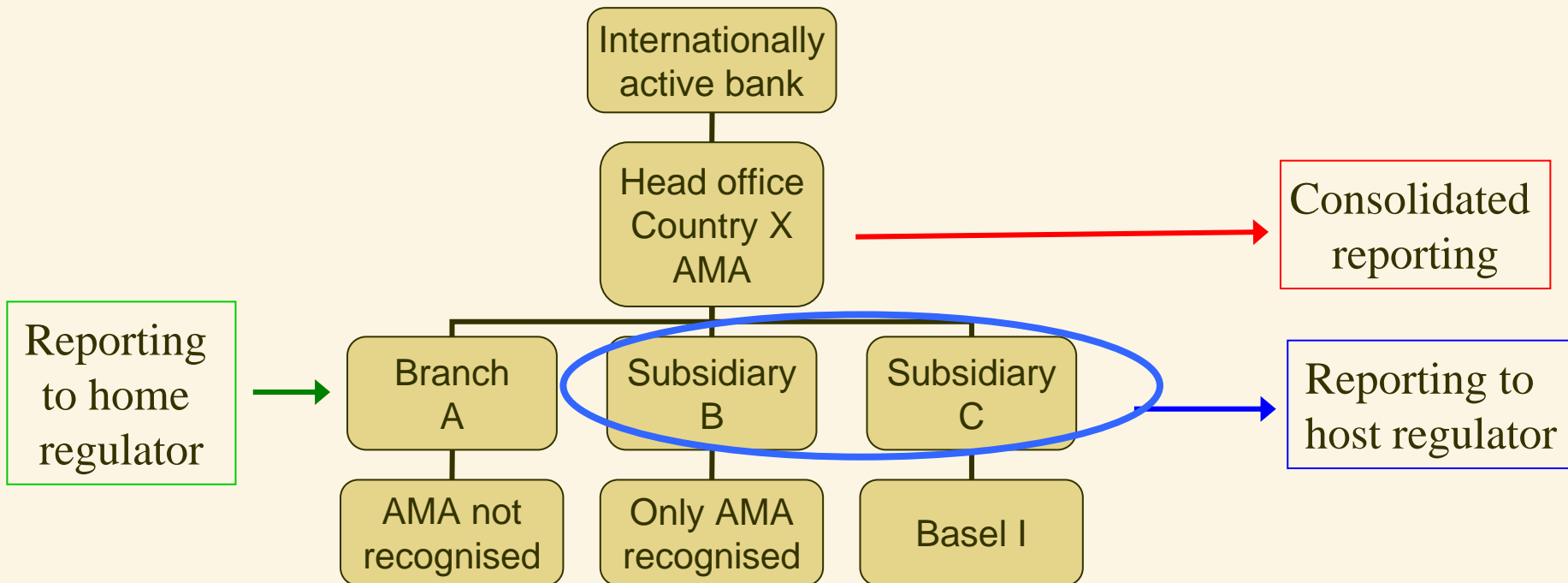


Home-Host issues

Home-host (or cross-border) issues are not unique to operational risk nor are they new, but under Basel II are likely to receive greater attention than they have to date



Home-host and the AMA





Home-host issues and the AMA

Banks want to develop AMAs on a ‘top-down’ basis ...

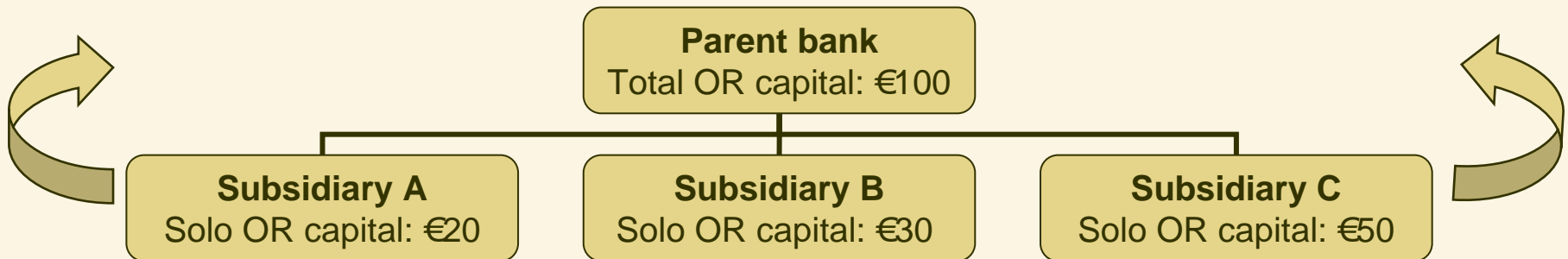
- Practical and logistical challenges:
 - Data
 - Efficiency
 - Regulatory burden
- Diversification benefits
 - Lower capital at entity level?

but supervisors need to ensure banks are adequately capitalised and effectively managed on a legal entity basis ...



Home-host issues and the AMA

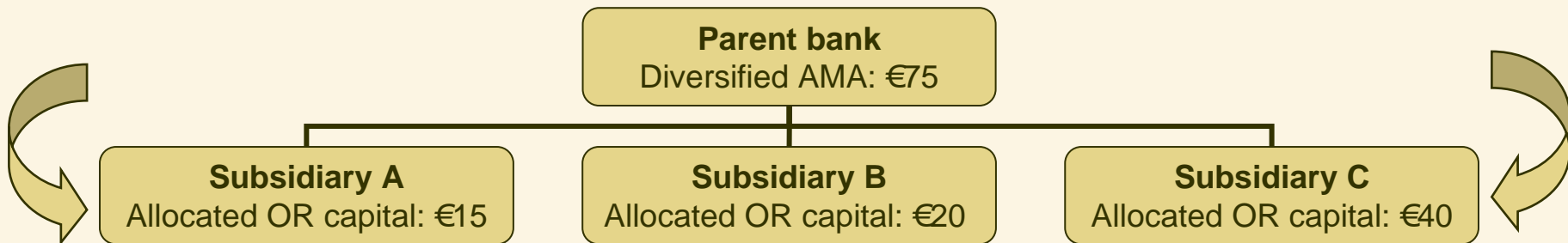
For example ... without allocation





Home-host issues and the AMA

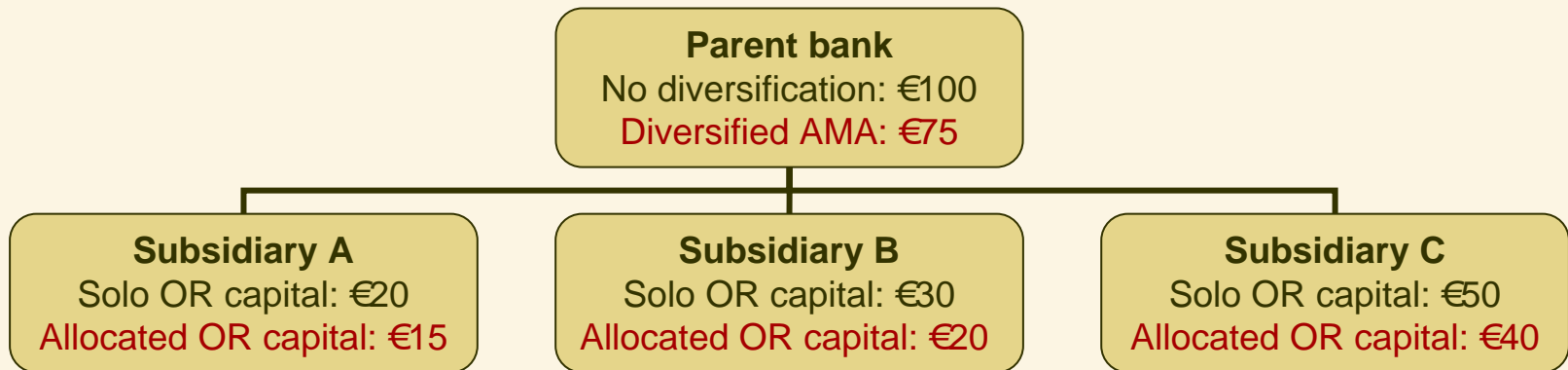
For example...with allocation





Home-host issues and the AMA

What to do?



Host supervisor concerns

Is capital transferable?

Corporate governance responsibilities of subsidiaries?

Legal responsibilities of supervisors?



Home-host issues and the AMA

A compromise solution – the “hybrid” approach

- *Principles for home-host recognition of AMA capital* (Jan 2004)
- “Significant” bank subs may not rely on allocated AMA capital
 - Significance determined by host supervisor
 - Stand-alone capital calculation (AMA or other) required
- “Non-significant” subsidiaries may rely on allocated AMA capital
 - Subject to host supervisory approval
 - Consistent across all entities and with internal capital allocation methodologies
 - Reflect the degree to which capital is not freely transferable across legal entities
- Supervisory responsibility to minimise burden/cost



Home-Host issues

How to achieve effective cross-border supervision?

- Goal: Maximise safety and soundness, minimise gaps and overlaps
- Establish formal and informal arrangements for information exchange and cooperation between home and host country supervisors



Wrapping up



Looking ahead

- *2005-2006(7)*: National rulemaking processes
- *Year-end 2006(7)*: BIA / TSA / ASA available for implementation
- *Year-end 2007(8)*: AMA available for implementation
- *2007(9)-2009(11)*: Floors in place
- *After 2010*: Basel 2.1? Basel 3?



Where do we go from here?

- Implementation challenges
 - Home-host
 - Validation
 - AMA
 - Pillar 2
 - LGD, etc.

- More intensive dialogue during the implementation phase
- Deeper mutual understanding of risk management practice of individual institutions
- Focus on essential elements
 → *Evolution to more principles-based framework*

- Clearer guidance on what is OK and what is not
- Less need for thinking within the bank, less need for dialogue with supervisors
 → *Evolution to more prescriptive framework*





Concluding remarks

- Publication of Basel II created new challenge of implementation
- Effective cooperation and coordination between home and host supervisors will be key to success of Basel II
- Beyond principles and formal arrangements, at the end of the day what matters is having the right person at the end of the line



Reference materials



Reference materials

- Range of practice in key elements of AMA (BCBS, Oct 2006)
- Home-host information sharing for effective Basel II implementation (BCBS, June 2006)
- The treatment of expected losses by banks using the AMA (BCBS Newsletter, Nov 2005)
- Principles for the home-host recognition of AMA operational risk capital (BCBS, Jan 2004)
- Operational risk transfer across financial sectors (Joint Forum, Aug 2003)
- High-level principles for the cross-border implementation of the New Accord (BCBS, Aug 2003)



Reference materials (cont'd)

- Sound practices for the management and supervision of operational risk (BCBS, Feb 2003)
- Outsourcing in financial services (Joint Forum, Feb 2005)
- Essential elements of a statement of cooperation between banking supervisors (BCBS, May 2001)
- The supervision of cross-border banking (BCBS, Oct 1996)
- May 2005 conference *Implementing an AMA for Operational Risk*
(<http://www.bos.frb.org/bankinfo/conevent/oprisk2005/index.htm>)



Questions?

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