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## Basel Committee Newsletter No. 7 (November 2005)

### The treatment of expected losses by banks using the AMA under the Basel II Framework

The purpose of this Newsletter is to set forth the views of the Operational Risk Subgroup (AIGOR) of the Basel Committee Accord Implementation Group regarding the treatment of expected operational risk losses in Advanced Measurement Approaches (AMA). This Newsletter was developed in response to requests from the industry for clarification on this issue, particularly with respect to the meaning of paragraph 669(b) of *International Convergence of Capital Measurement and Capital Standards: A Revised Framework* (Basel II Framework).

Paragraph 669(b) states that a bank may be allowed to base its operational risk capital calculations on unexpected losses (UL) alone only if the bank can demonstrate that it is adequately “capturing EL in its business practices”. More specifically, the bank must “demonstrate to the satisfaction of its national supervisor that it has measured and accounted for its expected loss (EL) exposure”. The AIGOR believes that further clarification of paragraph 669(b) could provide greater consistency in the implementation of the AMA.

Several issues have been raised regarding the measurement and treatment of EL for operational risk purposes. First, because Basel II allows considerable flexibility for banks implementing an AMA, banks have developed very different methods for determining operational risk capital with varying emphasis given to the calculation of EL relative to total capital. Second, the ability to establish accounting reserves in respect of expected future operational risk losses is severely limited in many jurisdictions. Third, data issues are a potential problem in that many banks have only collected historical operational risk losses exceeding a specified threshold. Moreover, most banks’ datasets tend to be based on relatively short time series and include very few, if any, high severity losses; where they exist, such losses can dominate banks’ historical loss experience. Together, these data issues may complicate the calculation of EL.

In light of the above, the AIGOR believes that the following principles for applying paragraph 669(b) may facilitate consistent implementation and still leave sufficient room for appropriate discretion by national supervisors:

1. For operational risk EL to be “measured” to the satisfaction of national supervisors, the bank’s measure of EL must be consistent with the EL-plus-UL capital charge calculated using the AMA model approved by supervisors. For operational risk EL to be “accounted for” to the satisfaction of national supervisors by means other than holding capital or establishing provisions, the bank must be able to demonstrate that the corresponding losses are highly predictable and reasonably stable, and that the estimation process is consistent over time.
2. The maximum offset for operational risk EL should be bounded by the EL exposure calculated by the bank’s AMA model approved by supervisors. While many supervisors may interpret this maximum offset as a statistical measure of expected

loss over the entire loss distribution, some supervisors may choose a more restrictive maximum offset.

3. Allowable offsets for operational risk EL must be clear capital substitutes or otherwise available to cover EL with a high degree of certainty over a one-year time horizon. Where the offset is something other than provisions, its availability should be limited to those business lines and event types with highly predictable, routine losses. Because exceptional operational risk losses do not fall within EL, specific reserves for any such events that have already occurred will not qualify as allowable EL offsets.
4. The bank is expected to clearly document how its operational risk EL is measured and accounted for, including how any EL offsets meet the conditions outlined above.

The principles articulated in this note are designed to be flexible enough to allow for a range of sound practices and to encourage continued work in this area, while also clarifying the AIGOR's expectations. These principles are not intended to amend Basel II or to introduce any new rules. The Basel Committee will continue to monitor industry practice through the Accord Implementation Group and may provide additional guidance as industry practices evolve.