Appendix III

The practical application of home-host principles for AMA operational risk capital

The Committee has received informal comments and questions from various industry participants on its recent publication of a paper on home-host supervisory principles for the advanced measurement approaches (AMA) for operational risk (AMA home-host paper).[1] Included in the AMA home-host paper is an outline of what is described as a "hybrid" approach to a group-wide AMA. While the AMA home-host paper was not intended to be a consultative paper, the Committee believes that it would be appropriate to elaborate certain aspects of its views on implementing home-host supervision of operational risk AMAs.

Significant subsidiaries

The Committee chose not to define "significance" in determining which internationally active banking subsidiaries[2] are ineligible to make use of an approved allocation mechanism. The Committee is aware of industry concerns about the extent to which stand-alone AMAs for subsidiaries could be required. It is not the Committee's intent that a large number of banking subsidiaries within a given banking group should be required to adopt stand-alone AMAs as opposed to using an approved allocation mechanism. The Committee recognises that only a small number of subsidiary banks in such a group may have the practical ability to calculate their own AMA capital requirements for operational risk, and that some supervisors may exercise national discretion in a manner that limits use of the AMA by banking organisations in their jurisdictions. The Committee expects that home and host supervisors will work together in implementing the New Accord to determine which internationally active subsidiaries can reasonably be deemed to be significant.

Assessment processes

While supervisory processes for assessing and - where required - approving AMAs will evolve over time, the Committee is mindful that, in developing such processes, supervisors should consider the burden that such processes impose on internationally active banking organisations. As a general rule, where a banking organisation wishes (or is required) to adopt an AMA at both the group-wide and subsidiary levels, the Committee believes that it would be beneficial for the supervisory assessment of the AMA models to be coordinated by the home supervisor. While this is ultimately a matter for discussion among home and host supervisors of a given banking organisation, it would be desirable for the home supervisor to receive a banking organisation's AMA submission and coordinate comments from host supervisors in jurisdictions where the AMA will be applied.[3] It is expected that the AMA submission would include, among other things, a description of the group-wide AMA; identification of significant subsidiaries that will use a stand-alone AMA; an explanation of how resources (information, staff, etc.) are shared between the group and subsidiaries that adopt a stand-alone AMA; identification of non-significant subsidiaries that may use an allocation mechanism from the group-wide AMA figure; and a description of the allocation mechanism and rollout plan, as applicable. Host supervisors will still need to be assured, however, that the board and senior management of a subsidiary bank understand the subsidiary's operational risk profile, including how its operational risks are managed, and approve its Pillar 1 methodology for determining its operational risk capital requirements, whether that methodology comprises a stand-alone AMA or an allocation mechanism.

Partial use

The Committee is aware that questions remain about the application of the partial use provisions of the operational risk rules where a banking group and its internationally active banking subsidiaries are using different approaches (i.e. where a significant internationally active banking subsidiary adopts a simpler approach on a stand-alone basis even though the banking group adopts a group-wide AMA, or vice-versa). Consequently, the Committee hopes to provide greater clarity on the appropriate supervisory treatment of such situations both in this note and through possible changes to the operational risk partial use rules.

While a banking group may choose to adopt a group-wide AMA, significant internationally active banking subsidiaries of such banking groups will not be required under the partial use rules of the New Accord to adopt an AMA on a stand-alone basis. Depending on domestic implementation of the New Accord, a significant internationally active banking subsidiary could choose (or be required by its host supervisor) to adopt a simpler approach on a permanent basis even if its parent adopts a group-wide AMA. In this case, the parent would not be in violation of the operational risk partial use rules provided that, after a reasonable transitional period, the AMA metrics relevant to the subsidiary's operations are reflected in the group-wide AMA.[4]

Conversely, in some cases a significant internationally active banking subsidiary may choose (or be required by its host supervisor) to adopt a stand-alone AMA. The parent of such a subsidiary would not be in violation of the operational risk partial use rules if it chose to adopt a simpler approach on a group-wide basis, even if it did so permanently.[5]

The Committee expects that jurisdictions will have some flexibility in applying the partial use provisions of the New Accord. Supervisors should exercise reasoned judgement in assessing the appropriateness of the roll-out of a banking organisation's AMA, especially where partial roll-out is a result of jurisdictions either requiring or prohibiting the use of certain approaches to operational risk and is not a result of a banking organisation seeking favourable capital treatment (i.e. "cherry-picking").

Ability to leverage group resources

The Committee is aware that a number of banking organisations are managed on a business line basis rather than on a legal entity basis for internal economic capital allocation and other purposes. Nevertheless, just as the board and senior management of a subsidiary must satisfy themselves regarding the reasonableness of that legal entity's methodology for determining its operational risk and other capital requirements, banking supervisors have a responsibility for ensuring that specific legal entities in their jurisdictions are adequately capitalised. The Committee acknowledges the inherent friction between a business line approach to managing a global banking operation and the need to satisfy the boards and host supervisors of subsidiaries regarding the effectiveness of risk management practices and adequacy of capital on a legal entity basis. However, the Committee is not convinced that the related challenges are insurmountable or that they are unique to the hybrid approach to a group-wide AMA.

The AMA home-host paper states that subsidiaries implementing a stand-alone AMA will be permitted to leverage the resources of the group in determining their operational risk capital requirements. The Committee anticipates that this leveraging would encompass not only internal data and quantitative methodologies, but also the more qualitative elements of an approved group-wide AMA, such as the manner in which the results of risk and control self-assessments and scenario analyses are incorporated into the subsidiary's stand-alone AMA. At the same time, however, the Committee expects that the board and senior management of those subsidiaries would exercise judgement throughout this process and adjust the group-wide analyses, where appropriate, to address the unique circumstances of the subsidiary relative to the group. A subsidiary's process for leveraging group resources within its stand-alone AMA and, in particular, for adjusting the results of group-wide analyses in its process would have to be transparent to its board and host supervisor.

Use test

Some concerns have been expressed that banks managed on a business line basis at the group-wide level will not be able to satisfy the so-called "use test" in the AMA requirements and therefore will be unable to qualify to adopt an AMA. The Committee does not share the view that banks that manage themselves on a business line basis will be unable to satisfy the use test at the level of a significant internationally active subsidiary that implements a stand-alone AMA. Such subsidiaries may make use of group-wide processes and resources - even if these processes and resources function primarily on a business line basis - so long as the board and senior management of the subsidiary have reasonable assurance that the manner in which they are used results in a regulatory capital requirement that is commensurate with that subsidiary's operational risk profile.

Future work

The Committee notes that many of the issues discussed here may apply to the internal ratings-based approach for credit risk as well. Consequently, the Committee will continue working to ensure that the New Accord is implemented in a manner that is as reasonable and consistent as possible. A number of exercises are currently underway in the Committee's Accord Implementation Group, including actual case studies, which will help supervisors to identify key implementation issues and concerns. This important work, which has focused primarily on credit risk to date but which will increasingly scope in operational risk as well, will continue throughout the period leading up to implementation of the new capital framework. The Committee is committed to maintaining a dialogue with banking organisations throughout this period in order to identify and address implementation-related concerns.

[1] *Principles for the home-host recognition of AMA operational risk capital*, January 2004 (available on the BIS website at http://www.bis.org/publ/bcbs106.htm).

[2] The AMA home-host paper applies specifically to internationally active banking subsidiaries because these subsidiaries will be subject to the scope of application of the New Accord. The stand-alone treatment of non-internationally active subsidiaries is not within the scope of the New Accord and is therefore a matter of domestic supervisory discretion.

[3] In accordance with the general home-host principles set forth in the Committee's August 2003 paper on *High-level principles for the cross-border implementation of the New Accord*, the Committee expects that home and relevant host supervisors will cooperate in both initial validation of an AMA and ongoing monitoring of a banking organisation's operational risk management.

[4] A significant internationally active banking subsidiary's exposure to, and management of, operational risk must be explicitly considered in the banking group's overall AMA calculation, even if that subsidiary uses a simpler approach - on a stand-alone basis - for its own regulatory capital purposes. Subject to the approval of the banking group's home supervisor, this requirement may not apply while the banking group is rolling out the AMA across its global operations in accordance with an approved rollout plan.

[5] The AMA partial use rules as currently drafted may prevent the parent from including the results of a subsidiary's AMA in the calculation of its global, consolidated capital requirements for operational risk. Changes to the rules are being considered that would permit this to occur in limited circumstances.