AMA Implementation

Executive Summary

The AMA Group[1] (AMAG) is pleased to be discussing the implementation of the operational risk management provisions of the Basel Accord with the federal banking regulatory agencies.

The AMAG supports the AMA and its fundamental goals of improving operational risk management practice and ensuring capital adequacy. To achieve these goals, the AMAG believes that the agencies will have to address two broad issues as they move from policy development into supervisory and examination practice:

- First, the AMA should remain principles-based. Examiner dialogue should emphasize and encourage management practices that are directionally correct and that contribute to broad desirable business objectives, rather than conform to particular specific prescriptions for processes and methodologies.

- Second, a proper balance between management and quantification has to be struck. The current emphasis on capital calculation issues should diminish over time and far more weight has to be given to sound management practice.

These two issues can be addressed. The forum that we are creating between the agencies and the industry can help to resolve them -- as well as more technical ones, as they arise. The agencies must keep alive the forward-thinking spirit embodied in the AMA documents to date. And, for its part, the industry must continue to invest in meaningful practice improvements.

The AMAG looks forward to working with the policymakers, supervisors and examiners of the federal banking regulatory agencies to make AMA implementation a success.

[1] The Advanced Measurement Approaches Group (AMAG) was formed in mid-2005 at the suggestion of the Inter-Agency Working Group on Operational Risk. The AMAG is open to any U.S.-based banking institution that is either mandated, opting in, or considering opting in to Basel II. Each member institution is represented on the AMAG by their senior officer responsible for operational risk management. Of the twenty-two or so US banking institutions that are currently viewed as mandatory or opt-in Basel II institutions, seventeen are members of the AMAG. The Risk Management Association (RMA) provides the secretariat for the AMAG. See the attached list of members.

Background

The AMAG understands that the fundamental goals of the US federal banking regulatory agencies in implementing the AMA are to:

- Encourage improvements in operational risk management practice; and
- Ensure that the regulatory capital set aside by AMA banks for operational risk contributes adequately to their individual solvency and to the safety and soundness of the US banking system as a whole.

The AMAG strongly endorses the AMA and these two goals, and supports the agencies as they work to realize them.

For both the regulatory community and the industry, implementation of the AMA presents challenges that are different from the A-IRB for credit risk. The differences arise from the principles-based nature of the AMA, and a correspondingly greater emphasis on risk management as opposed to risk measurement. This principles orientation and the emphasis on risk management are both essential to the success of the AMA. The agencies must guard against the danger that they might be diluted as the AMA is translated from policy into practice by supervisors and examiners, and by bank boards and management.

Principles-Based Supervision

While a few AMAG members have found that the dialogue with their examiners has closely mirrored their discussions with policymakers, many have found that this dialogue with the agency policymakers is very different in tone. With the policymakers, the challenges of operational risk management as a discipline are well understood; innovation is encouraged and "directionally correct" is the agreed-upon theme. The discussions with examiners feel different. There does not appear to be the same open-mindedness about choices among acceptable practices. Operational risk is evolving and in several areas there are still several defensible ways of achieving a particular management objective.

While the agencies must of course be consistent in implementing standards, the AMAG would hope to see consistency achieved by setting clear requirements for ends as opposed to means. In other words, there should continue to be considerable flexibility about the processes and methodologies individual institutions use, reflective of their unique operational environments and risks, provided they contribute effectively to broad well-defined specific business objectives.

The regulatory capital regime as a whole should give banks an incentive to improve their operational risk management practices. Specifically, they should have an incentive to opt into the AMA and meet its standards. The details of AMA supervision and examination should encourage prudent innovation and ongoing improvements in practice. Supervision and examination must not become so prescriptive that it freezes practice at any point in time. Equally, the industry needs to respond to these incentives and continue to innovate and invest, so as to increase the practical value of operational risk management and to improve the quality of capital estimates over time.

Today, there are a wide variety of ways to manage operational risk and to estimate an associated capital requirement that meet appropriate standards. To some extent, this reflects the immaturity of the discipline and the current number of acceptable ways of doing things may very well diminish as time passes. However, the particular circumstances of institutions vary a great deal, and these circumstances can have a major impact on how risk should be managed and capital should be estimated. A variety of approaches and methodologies are likely to be a permanent aspect of good practice for the foreseeable future. [2]

Balance Between Quantification and Management

Since quantification is one of the newest aspects of operational risk management, and since the regulators must approve models by 1/1/09, it is logical that they have placed a priority on issues of quantification up to now. During QIS 4 and the LDCE, the regulatory dialogue has focused on technical issues of capital estimation and the two major conferences organized by the regulators in the past three years have focused on measurement and quantification. This focus has been evident in industry conferences as well. Going forward, the dialogue must become more balanced so that good risk management processes, and corporate culture receive much more emphasis.

An ongoing emphasis on quantification would be undesirable:

- It would take away from the time needed to devote to risk management
- It would create a perception that operational risk management is fundamentally about calculating a capital number rather than managing risks
- It would imply a degree of precision that does not exist at this time
- It might cause operational risk management to become a compliance activity devoted to calculating a number, rather than an activity that proactively identifies and manages material risks.

Going forward more thought needs to be given to understanding what it means to develop and apply risk management frameworks and processes that meet appropriate standards of relevance, comprehensiveness, effectiveness, reliability and integrity.

[2] The Executive Summary of the ANPR said: "Under the AMA, each banking organization would be able to use its own methodology for assessing exposure to operational risk, provided the methodology is comprehensive and results in a capital charge that is reflective of the operational risk experience of the organization." And then it went on to say: "The goal is to establish a supervisory framework within which all institutions must develop their internal systems, leaving exact details to each institution."

A New Forum

So the main challenges in AMA implementation are twofold. On the one hand, it is to retain the flexibility with regard to specific processes and methodologies that is necessary to accommodate legitimate differences in practices and to continue to foster innovation. On the other hand, it is to ensure that a suitable balance between quantification and management issues is struck going forward.

These challenges can be met. The forum that we are creating between the agencies and the industry can help to resolve the underlying issues in each area -- as well as more technical ones as they arise. The AMAG therefore looks forward to working with the policymakers, supervisors and examiners of the federal banking regulatory agencies to formulate specific suggestions in order to make AMA implementation a success.

The AMAG believes this implementation can be a win/win for all parties. The Accord reflects sound risk management practices. As regulatory policies become supervisory practices, the forward-thinking spirit of AMA, evident in the Basel documents and in the ANPR, can be fully realized.

AMA Group Members

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Support:

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Notes:

* AMAG Chair
** Steering Committee Member