



Discussion Paper

Implementation of the Basel II Capital Framework

4. Advanced measurement approaches to operational risk

4 October 2005

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Introduction

The Basel II Framework introduces a regulatory capital charge for operational risk. Operational risk is defined as the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. The definition includes legal risk but excludes strategic and reputational risk.

Consistent with the approach taken for credit risk, the Basel II Framework includes a number of alternative options for determining the regulatory capital charge for operational risk. As with the regulatory capital charge for credit risk, APRA expects that the vast majority of Australian banks, building societies and credit unions will use the standardised approach in determining their regulatory capital charge for operational risk.¹

Australia's internationally operating banks are seeking to implement the advanced measurement approaches to operational risk (AMA). These are the most complex approaches that will be available to an authorised deposit-taking institution (ADI), and are based on an ADI's own quantitative model.

This discussion paper introduces the draft prudential standard for the AMA, *APS 115 Capital Adequacy: Advanced Measurement Approaches to Operational Risk* (APS 115).

ADIs will require individual approval from APRA before the AMA can be used for regulatory capital purposes.

Prudential standard

APS 115 sets out the criteria that must be met by an ADI to obtain approval from APRA to use its own operational risk measurement system for AMA purposes. The standard does not require that an ADI's operational risk measurement system be based on any particular measurement technique but does require systematic and transparent operational risk management and measurement practices that are capable of independent review and validation. Other main requirements of the draft standard are:

- an ADI must have in place a framework to manage, measure and monitor operational risk that is commensurate with the nature, scale and complexity of the ADI's operations;
- the ADI must collect operational risk loss data;
- the ADI's operational risk measurement system must take into account internal and relevant external data, scenario analysis and specific indicators of the ADI's current and planned future operational risk profile and factors related to the assessment of the ADI's internal control framework;
- the regulatory capital charge for operational risk, as determined by the ADI's own operational risk measurement system, must cover unexpected and expected operational risk losses unless the ADI has appropriately accounted for its expected loss exposure by a method approved by APRA as being equivalent to holding regulatory capital;
- the operational risk regulatory capital requirement must be comparable to a 99.9 per cent confidence level and a one-year holding period; and
- subject to meeting certain criteria, an ADI may recognise the risk-mitigating effect of appropriate insurance in determining its operational risk regulatory capital charge up to a limit of 20 per cent of the total operational risk regulatory capital charge.

¹ The draft prudential standard APS 114 Capital Adequacy: Standardised Approach to Operational Risk was released by APRA on 28 July 2005.

The draft APS 115 is available on the APRA web site www.apra.gov.au. Written submissions on the draft standard should be forwarded by 28 February 2006 to:

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Outstanding issues

The draft APS 115 is complete with the exception of guidance notes on allocating operational risk capital within a banking group and cross-border guidance. In respect of these two guidance notes, debate is continuing among supervisors on the appropriateness of particular techniques to allocate operational risk capital to the various individual legal entities within a banking group. An international forum has been established to address this issue, which is a significant one for the majority of ADIs that are likely to adopt the AMA. In APRA's view, it would be beneficial to continue discussions with other jurisdictions before finalising its position.

The holding of capital for expected operational risk losses and the criteria for assessing correlation assumptions are two other issues under active discussion by international supervisors. Depending on the outcome of these discussions and the development of banks' own practices, APRA may provide further guidance on these issues.

Policy issues surrounding APS 115

APS 115 requires the estimation of a distribution of aggregated potential operational risk losses across the ADI or a set of operational risk loss distributions for sub-parts of the ADI's operations. While the Basel II proposals do not explicitly state that a distribution of potential operational risk losses has to be estimated, APRA does not consider that the quantitative criteria in the Framework could be satisfied without the use of an approach that incorporates some form of distribution of potential operational risk losses. Indeed, most operational risk measurement systems that have been developed by international banks, including Australian banks, incorporate a distribution of potential operational risk losses incurred over a certain time horizon.

Unlike the proposals on the internal ratings-based approach to credit risk, the Basel II proposals on the AMA are relatively high level in nature owing, in part, to the comparative stage of development of operational risk quantitative techniques. APS 115 provides additional detail to assist ADIs in determining the criteria that are necessary to demonstrate compliance with the Basel II proposals. In particular, APS 115 includes detailed qualitative requirements on the basis of which an ADI can demonstrate to APRA that the AMA permeates the management of the ADI's business.



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