Guernsey Financial
Services Commission

MODULE 3

Guidance to completing the Operational Risk module of BSL/2

Operational Risk

Section 1 – Introduction

This module relates to reporting operational risk by Guernsey licensed banking subsidiaries under the Operational Risk module of the BSL/2 return. “Basel II” is the revised international capital framework set out by the Basel Committee on Banking Supervision in its paper “International Convergence of Capital Measurement and Capital Standards: A Revised Framework - Comprehensive Version”, published in June 2006 (“ the Basel II document”).

Operational risk is defined in the Basel II document as the risk of loss resulting from:

- inadequate or failed internal processes and systems
- the actions of people; or
- external events.

The Basel II document states that this definition includes legal risk, but excludes strategic and reputational risk.

There are four approaches to calculating the operational risk capital requirement within Basel II. The Basic Indicator Approach (“BIA”); the Standardised Approach (“TSA”); the Alternative Standardised Approach (“ASA”) and the Advanced Measurement Approach (“AMA”). The BIA and TSA are considered appropriate for Guernsey licensed banks. The ASA may be appropriate, dependent upon a bank’s risk profile.

Each of these three approaches has an associated reporting form in the module that must be used to derive the operational risk capital requirement, a calculation based on income data from the past three years. These three approaches comprise the operational risk module of BSL/2. The Commission will provide banks with a BSL/2 that reflects the particular approach agreed with the Commission.

Where a bank has been approved to use the AMA it will be required to provide such reporting as has been agreed with the Commission during the approval process.

The operational risk module of form BSL/2 is only to be completed by banks operating as subsidiaries in the Bailiwick of Guernsey. Licensed branches should not complete this module.

Section 2 – Definition of Year of Operation

Under the BIA and TSA, the bank’s capital charge for operational risk is calculated using gross income data from the last three years.

The ASA also offers the option of calculating the capital charge through using the average volume of loans and advances (“loans and advances” hereafter

are simply referred to as “advances”) for each of those years. Year one is the last completed accounting year, years two and three are the two immediately preceding accounting years.

The Risk Weighted Assets (“RWA”) “equivalent amount” is derived by multiplying the capital charge by 12.5, as established in Basel II. This is combined with the RWA derived for credit risk and other risks to arrive at the total RWA of the bank.

A bank should treat any partial year of operation of six months or more as a full year. Any partial year of operation of less than six months should be disregarded. If any partial year is counted as a full year, the gross income of that partial year should be annualised. Under the ASA, the mean average of the amount of advances outstanding at the end of each full calendar quarter within that partial year should be taken as the average level of advances for that year.

An illustration of calculating the gross income and advances in the retail and commercial banking business lines for partial and full years of operation is shown in **annex A**.

Section 3 – Guidance on Form Completion

General layout

There are three different reporting forms covering:

- Basic Indicator Approach, Form 1.1;
- The Standardised Approach, Form 1.2; and
- Alternative Standardised Approach, Form 1.3.

The bank will have agreed with the Commission which approach it will use. A completed example of each form is included in ***annex B***.

Section A of each form asks if this approach is the agreed approach to be used by the bank. This section should be completed by entering “YES” in the form for the agreed approach, and “NO” in the forms for the other two approaches. The forms where “NO” has been indicated should be left blank.

Form 1.1 Basic Indicator Approach

The capital charge for operational risk under the BIA is calculated as 15% (denoted “Alpha”) of the average gross income over the past three years, ignoring those years where income was not positive.

Section B: Gross Income comprising:

Item	Item Name	Definition
B.1	Net Interest Income	*Interest income net of interest expenses, for each of the three preceding years, gross of any provisions (e.g. for unpaid interest).*
B.2	Net Non-Interest Income	*Net non-interest income for each of the three preceding years. Note that this is gross of provisions and gross of operating expenses (including fees paid to outsourcing service providers) and should exclude realised profits/losses from the sale of securities in the banking book and extraordinary or irregular items as well as income derived from insurance.*

Section C: BIA Calculation

“Average Income” is calculated as the sum of the two items, shown in section B, for each year where the said sum was positive, divided by the number of those years.

Section D: BIA Requirement

The capital charge for the BIA is calculated as 15% of Average Income. The RWA equivalent for the BIA is calculated by multiplying the capital charge by 12.5.

Form 1.2 Standardised Approach to Operational Risk ("TSA")

The TSA requires the bank to allocate income by business line for each of the previous three years. Multiplying these income amounts by the appropriate scaling factor for that business line (denoted "Beta") gives the capital charge for each of these lines. Adding together the capital charges of each line gives the total charge for a year. Beta varies from 12% to 18%, as specified in Basel II. The RWA equivalent is derived from the average of these yearly capital charges, ignoring those where the capital charge derived is not positive.

Section B: Income

Item	Item Name	Beta	Definition
B.1	Corporate Finance	18%	▪ *Net fees and commission earned.*
B.2	Trading & Sales	18%	▪ *Profits/losses on instruments held for trading purposes, net of funding costs.* ▪ *Fees from wholesale broking.*
B.3	Retail Banking	12%	▪ *Net interest income on advances to retail customers and small businesses treated as retail.* ▪ *Fees related to retail activities.* ▪ *Net income from swaps and derivatives held to hedge the retail banking book.* ▪ *Income on purchased retail receivables.*
B.4	Commercial Banking	15%	▪ *Net interest income on advances to corporate, bank and sovereign customers.* ▪ *Income on purchased corporate receivables.* ▪ *Fees related to commercial banking activities including commitments, guarantees and bills of exchange.* ▪ *Net income (e.g. from coupons and dividends) on securities held in the banking book.* ▪ *Profits/losses on swaps and derivatives held to hedge the commercial banking book.*
B.5	Payment & Settlement	18%	▪ *Net fees/commissions earned.* ▪ *Fees for provision of payments/settlement facilities for wholesale counterparties.*
B.6	Agency Services	15%	▪ *Net fees and commission earned.*
B.7	Asset Management	12%	▪ *Net fees and commission earned.*
B.8	Retail Brokerage	12%	▪ *Net fees and commission earned.*

All income of the bank must be allocated to a business line in accordance with the principles and guidance of business line mapping shown in **annex C**.

Section C: Capital Charge

The capital charge for each year is derived by:

- Multiplying the income reported in Section B by the appropriate Beta for each business line to get the charge for that line; and
- Adding together the eight capital charges thus calculated for the business lines.

In any given year, positive capital charges for any individual lines may be offset by negative capital charges for other business lines in that year without limit. However, where the aggregate capital charge across all business lines within a given year is negative, then the input to the numerator for that year will be zero.

Section D: “TSA Requirement”

The capital charge for the TSA is calculated as the sum of the three yearly capital charges, where positive, divided by the number of those years. The “RWA equivalent” for the TSA is calculated by multiplying this capital charge by 12.5.

Form 1.3 Alternative Standardised Approach (“ASA”)

The ASA is an available option within Basel II. It uses an alternative proxy for operational risk in respect of both retail and corporate lending. Total retail and corporate advances (not risk weighted and gross of provisions) are multiplied by a fixed factor 0.035 (i.e. 3.5%) which has been calculated by the Basel Committee (denoted “m”).

The capital charge is then calculated by applying a scale factor, Beta, of 15% to this amount, then adding a sum equivalent to 18% of all other income.

Section B: “Retail/Commercial Lending – Volume”

Enter average retail and commercial lending balances based on quarter-end balances of the relevant year.

Section C: Income

Item	Item Name	Beta	Definition
C.1	Retail/ Commercial Lending	15%	*3.5% of the average volume reported in Section B above, as an alternative proxy for operational risk from these two business lines.*
C.2	All Other income	18%	*Gross income from all business lines except retail and commercial lending as per the TSA definitions*

All income of the bank must be allocated to a business line in accordance with the principles and guidance of business line mapping shown in **annex D**.

Section D: Capital Charge

The capital charge for each year is derived by:

- Multiplying the income reported in Section C by the appropriate "Beta" for each group of business lines to get the charge for that group; and
- Adding together both capital charges thus calculated for the business lines.

A negative capital charge for "All other income" can offset that derived for Retail/Commercial lending. However, where the aggregate capital charge within a given year is negative, then the input to the numerator for that year will be zero.

Section E: "ASA Requirement"

The capital charge for the ASA is calculated as the sum of the three yearly capital charges, where positive, divided by the number of those years. The "RWA equivalent" for the ASA is calculated by multiplying this capital charge by 12.5.

Annex A – Examples of Full and Partial Year Treatments

Example 1: Three or more full years

If a bank:

- Had an accounting year that matched the calendar year;
- Had commenced operations prior to 1/1/2006; and
- Wished to report for Q4 2008, or any of the first three quarters in 2009, then:

“Last Year” would be 2008: report full year’s gross income and, for the ASA only, report the average of advances as reported at end Q1, Q2, Q3 and Q4 2008.

“1 year prior” would be 2007: derived in equivalent fashion to “Last Year”.

“2 years prior” would be 2006.

Example 2: One full year plus one year of more than six months duration

If a bank:

- Had an accounting year that matched the calendar year;
- Had commenced operations on 1/4/2007; and
- Wished to report for Q4 2008, or any of the first three quarters in 2009, then:

“Last Year” would be 2008: report full year’s gross income and, for the ASA only, report the average of advances as reported at end Q1, Q2, Q3 and Q4 2008.

“1 year prior” would be 2007: annualise this partial year’s gross income; in this case by dividing by nine (number of months of operation) and multiplying by twelve, and, only for the ASA, report the average of advances reported at end Q2, Q3 and Q4 2007.

“2 years prior” would be 2006: report zero for gross income and, for the ASA only, report zero advances. The calculation disregards these figures.

Example 3: Two full years plus one year of less than 6 months duration

If a bank:

- Had an accounting year that matched the calendar year;
- Had commenced operations on 1/9/2006; and
- Wished to report for Q4 2008, or any of the first three quarters in 2009, then:

“Last Year” would be 2008: report full year’s gross income and, for the ASA only, report the average of advances as reported at end Q1, Q2, Q3 and Q4 2008.

“1 year prior” would be 2007: derived in equivalent fashion to “Last Year”.

“2 years prior” would be 2006: report zero for gross income and, for the ASA only, report zero advances. The calculation disregards these figures.

Annex B – Completion Examples

Introduction

The example data given in the tables below has been used to complete the forms overleaf for illustrative purposes.

Whilst the forms have been completed for all three options in reality only one form would be completed for the option that the bank had agreed with the Commission it would use, with the forms left blank for the other two options.

Gross Income

	2008		**2007**		**2006**	
Business Line	**Net Interest Income**	**Net Non-Interest Income**	**Net Interest Income**	**Net Non-Interest Income**	**Net Interest Income**	**Net Non-Interest Income**
Corporate Finance	0	1,200	0	1,100	0	1,000
Trading & Sales	0	2,000	0	-1,000	0	0
Retail Banking	5,000	-1,000	5,500	-1,000	6,000	-1,000
Commercial Banking	1,000	-2,000	-1,000	-3,000	0	0
Payment & Settlement	0	300	0	150	0	200
Agency Services	0	55	0	45	0	50
Asset Management	0	1000	0	-500	0	0
Retail Brokerage	0	1500	0	-500	0	0

Loans and Advances

Business Line	**2008**	**2007**	**2006**
Retail	80,000	90,000	100,000
Commercial	80,000	40,000	0

Completed Forms

MODULE 3

BASIC INDICATOR APPROACH OPERATIONAL RISK ("BIA")

Item	Nature of Item	Value
A	BIA as agreed approach?	YES

Item	Nature of Item	Last year	1 year prior	2 years prior
B	Gross Income comprising:			
B.1	Net Interest Income	6,000	4,500	6,000
B.2	Net Non-Interest Income	3,055	(4,705)	250
	TOTAL	9,055	(205)	6,250

Item	Nature of Item	Value
C	BIA Calculation	
C.1	Average Income, where positive	7,653
C.2	Alpha	15%

Item	Nature of Item	Capital Charge	RWA Equivalent
D	BIA Requirement	1,148	1,450

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THE STANDARDISED APPROACH TO OPERATIONAL RISK ("TSA")

Item	Nature of Item	Value
A	TSA as agreed approach?	YES

Item	Nature of Item	Last year	1 year prior	
B	Income			
B.1	Corporate Finance	1,200	1,100	
B.2	Trading and sales	2,000	(1,000)	
B.3	Retail banking	4,000	4,500	
B.4	Commercial banking	(1,000)	(4,000)	
B.5	Payment and settlement	300	150	
B.6	Agency services	55	45	
B.7	Asset management	1,000	(500)	
B.8	Retail Brokerage	1,500	(500)	
	TOTAL	9,055	(205)	

Item	Nature of Item	Beta	Last year	1 year prior	
C	Capital Charge				
C.1	Corporate Finance	18%	216	198	
C.2	Trading and sales	18%	360	(180)	
C.3	Retail banking	12%	480	540	
C.4	Commercial banking	15%	(150)	(600)	
C.5	Payment and settlement	18%	54	27	
C.6	Agency services	15%	8	7	
C.7	Asset management	12%	120	(60)	
C.8	Retail Brokerage	12%	180	(60)	
	TOTAL		1,268	0	

Item	Nature of Item	Capital Charge	RWA Equivalent
D	TSA Requirement	1,046	13,075

MODULE 3

ALTERNATIVE STANDARDISED APPROACH TO OPERATIONAL RISK ("ASA"

Item	Nature of Item	Value
A	**ASA as agreed approach?**	**YES**

Item	Nature of Item	Last year	1 year prior	2 years prior
B	Retail/Commercial Lending - Volume	160,000	130,000	100,000

Item	Nature of Item	Fixed factor "m"	Last year	1 year prior	2 years prior
C	**Income**				
C.1	Retail/Commercial Lending	3.5%	**5,600**	**4,550**	**3,500**
C.2	All other income		6,055	(705)	1,250
	TOTAL		**11,655**	**3,845**	**4,750**

Item	Nature of Item	Beta	Last year	1 year prior	2 years prior
D	**Capital Charge**				
D.1	Retail/Commercial Lending	15%	**840**	**683**	**525**
D.2	All other income	18%	**1,090**	**(127)**	**225**
	TOTAL		**1,930**	**556**	**750**

Item	Nature of Item	Capital Charge	RWA Equivalent
E	**ASA Requirement**	**1,079**	**13,488**

Annex C - Principles and Guidance for Business Line Mapping under the Standardised Approach

Summary of Business Lines, Activity Groups and Income Definitions

Business Line	Major Business Segments	Activity Groups	Charge as % of gross income	Gross income definition
Corporate Finance	Corporate Finance Municipal/Government Finance Merchant Banking Advisory Services	Mergers and acquisitions, underwriting, privatisations, securitisation, research, debt (government / high yield), equity, syndications, IPO, secondary private placements	18	Net fees / commissions earned in each business line.
Trading & Sales	Sales Market Making Proprietary Positions Treasury	Fixed income, equity, foreign exchange, commodities, credit, funding, own position securities, lending and repos, brokerage, debt, prime brokerage	18	Profits / losses on instruments held for trading purposes, net of funding cost. Fees from wholesale broking.
Retail Banking	Retail Banking	Retail lending and deposits, banking services, trust and estates	12	Net interest income on loans and advances to retail customers and small businesses treated as retail. Fees related to traditional retail activities. Net income from swaps and derivatives held to hedge the retail banking book. Income on purchased retail receivables.
	Private Banking	Private lending and deposits, banking services, trusts and estates, investment advice		
	Card Services	Merchant / Commercial / Corporate cards, private labels and retail		
Commercial Banking	Commercial Banking	Project finance, real estate, export finance, trade finance, factoring, leasing, lending, guarantees, bills of exchange	15	Net interest income on loans and advances to corporate, inter-bank and sovereign customers. Income on purchased corporate receivables. Fees related to traditional commercial banking

				activities including commitments, guarantees, bills of exchange. Net interest income on securities held in the banking book. Profits/losses on swaps and derivatives held to hedge the commercial banking book.
Payment & Settlement	External Clients	Payments and collections, funds transfer, clearing and settlement	18	Net fees / commissions earned. Fees to cover provision of payments / settlement facilities for wholesale counterparties.
Agency Services	Custody	Escrow, depository receipts, securities lending (customers), corporate actions	15	Net fees / commissions earned in each business.
	Corporate Agency	Issuer and paying agents		
	Corporate Trust			
Asset Management	Discretionary Fund Management	Pooled, segregated, retail, institutional, closed, open, private equity	12	Net fees / commissions earned in each business.
	Non-Discretionary Fund Management	Pooled, segregated, retail, institution, closed, open		
Retail Brokerage	Retail Brokerage	Execution and full service	12	Net fees / commissions earned in each business.

Annex C - Principles and Guidance for Business Line Mapping under the Standardised Approach - continued

(a) All activities must be mapped into the eight business lines in a mutually exclusive and jointly exhaustive manner. All income must be allocated to one of the business lines.

(b) Any banking or non-banking activity which cannot be readily mapped into the business line framework, but which represents an ancillary function to an activity included in the framework, must be allocated to the business line it supports. If more than one business line is supported through the ancillary activity, an objective mapping criterion must be consistently adopted and the reasoning behind adopting that criterion recorded by the bank.

(c) When mapping gross income, if an activity cannot be mapped into a particular business line then the business line yielding the highest capital charge must be used. The same business line will apply to any associated ancillary activity.

(d) Banks may use internal pricing methods to allocate gross income between business lines provided that total gross income for the bank (as would be recorded under the Basic Indicator Approach) still equals the sum of gross income for the eight business lines.

(e) The mapping of activities into business lines for operational risk capital purposes must be consistent with the definitions of business lines used for regulatory capital calculations in other risk categories, i.e. credit and market risk. Any deviations from this principle must be clearly explained and documented.

(f) The mapping process used must be clearly documented. In particular, written business line definitions must be clear and detailed enough to allow third parties to replicate the business line mapping. Documentation must, among other things, clearly record any exceptions or overrides.

(g) Processes must be in place to define the mapping of any new activities or products.

(h) Senior management is responsible for the mapping policy (which is subject to the approval by the board of directors).

(i) The mapping process to business lines must be subject to independent review.

Supplementary Business Line Mapping Guidance

There are a variety of valid approaches that banks can use to map their activities to the eight business lines, provided the approach used meets the business line mapping principles (above). Nevertheless, the Commission is aware that some banks would welcome further guidance. The following is therefore an example of one possible approach that could be used by a bank to map its ***gross income***:

Gross income for retail banking consists of net interest income on loans and advances to retail customers (which includes private banking customers) and SMEs treated as retail, plus fees related to traditional retail activities, net income from swaps and derivatives held to hedge the retail banking book, and income on purchased retail receivables. To calculate net interest income for retail banking, a bank should take the interest earned on its loans and advances to retail customers less the average cost of funding of the loans (from whatever source - retail or other deposits).

Similarly, gross income for commercial banking consists of the net interest income on loans and advances to corporate (plus SMEs treated as corporate), *interbank* (including placements with other group or parent banks) and sovereign customers and income on purchased corporate receivables, plus fees related to traditional commercial banking activities including commitments, guarantees, bills of exchange, net income (e.g. from coupons and dividends) on securities held in the banking book, and profits/losses on swaps and derivatives held to hedge the commercial banking book. Again, the calculation of net interest income is based on interest earned on loans and advances to corporate, *interbank* and sovereign customers less the average cost of funding for these loans (from whatever source).

For trading and sales, gross income consists of profits/losses on instruments held for trading purposes (i.e. in the mark-to-market book), net of funding cost, plus fees from wholesale broking.

For the other five business lines, gross income consists primarily of the net fees/commissions earned in each of these businesses. ***Payment and settlement*** consists of fees to cover provision of payment/settlement facilities for wholesale counterparties. ***Asset management*** is management of assets on behalf of others.

Annex D – Principles and Guidance for Business Line Mapping under the Alternative Standardised Approach

Principles for Business Line Mapping

(a) All activities must be mapped into the two aggregated business lines (retail and commercial banking together, and the six other together) in a mutually exclusive and jointly exhaustive manner. All income must be allocated to one of the business lines.

(b) Any banking or non-banking activity which cannot be readily mapped into the business line framework, but which represents an ancillary function to an activity included in the framework, must be allocated to the business line it supports. If more than one business line is supported through the ancillary activity, an objective mapping criterion must be consistently adopted and the reasoning behind adopting that criterion recorded by the bank.

(c) The mapping of activities into business lines for operational risk capital purposes must be consistent with the definitions of business lines used for regulatory capital calculations in other risk categories, i.e. credit and market risk. Any deviations from this principle must be clearly explained and documented.

(d) The mapping process used must be clearly documented. In particular, written business line definitions must be clear and detailed enough to allow third parties to replicate the business line mapping. Documentation must, among other things, clearly record any exceptions or overrides.

(e) Processes must be in place to define the mapping of any new activities or products.

(f) Senior management is responsible for the mapping policy (which is subject to the approval by the board of directors).

(g) The mapping process to business lines must be subject to independent review.

Supplementary Business Line Mapping Guidance

There are a variety of valid approaches that banks can use to map their activities to the aggregated business lines, provided the approach used meets the business line mapping principles (above). Nevertheless, the Commission is aware that some banks would welcome further guidance. The following is therefore an example of one possible approach that could be used by a bank to map its ***total loans and advances*** (for retail and commercial banking aggregated), and ***gross income*** for the other six business lines (aggregated):

Total loans and advances in the retail banking business line consist of the total drawn amounts (gross of provisions) in the following credit portfolios: retail (including private banking), SMEs treated as retail, and purchased retail receivables. For ***commercial banking***, total loans and advances consist of the drawn amounts (gross of provisions) in the following credit portfolios: corporate, sovereign, interbank

(including placements with other group, or parent, banks), specialised lending, SMEs treated as corporate and purchased corporate receivables. The book value of securities held in the banking book should also be included.

In respect of the other six business lines, which are based on gross income, in order to disaggregate them from income derived from retail and commercial banking the following may help:

For trading and sales, gross income consists of profits/losses on instruments held for trading purposes (i.e. in the mark-to-market banking book), net of funding cost, plus fees from wholesale broking.

For the other five business lines, gross income consists primarily of the net fees/commissions earned in each of these business activities. ***Payment and settlement*** consists of fees to cover provision of payment/settlement facilities for wholesale counterparties. ***Asset management*** is management of assets on behalf of others.

Schedule 1 – Qualifying Criteria – The Standardised Approach

Qualifying criteria for all banks wishing to use the Standardised Approach

(a) In order to qualify for use of the Standardised Approach, a bank must satisfy the Commission that, as a minimum:

- Its board of directors and senior management, as appropriate, are actively involved in the oversight of the operational risk management framework;
- It has an operational risk management system that is conceptually sound and is implemented with integrity; and
- It has sufficient resources in the use of the approach in the major business lines as well as the control and audit areas.

(b) The Commission will have the right to insist on a period of initial monitoring of a bank's Standardised Approach before it is used for regulatory capital purposes.

(c) A bank must develop specific policies and have documented criteria for mapping gross income for current business lines and activities into the standardised framework. The criteria must be reviewed and adjusted for new or changing business activities as appropriate. The principles for business line mapping are set out in ***annex C***.

The Commission also recommends that banks which are not considered to be internationally active banks should nevertheless have due regard to the additional qualifying criteria stated below. The Commission will consider the additional criteria, taking into account the nature of a bank's activities, when assessing whether a bank may qualify to adopt the Standardised Approach.

Additional qualifying criteria for internationally active banks[1]

An internationally active bank wishing to use the Standardised Approach must meet the following additional criteria:

(a) The bank must have an operational risk management system with clear responsibilities assigned to an operational risk management function. The operational risk management function is responsible for developing strategies to identify, assess, monitor and control/mitigate operational risk; for codifying firm-level policies and procedures concerning operational risk management and controls; for the design and implementation of the firm's operational risk assessment methodology; and for the design and implementation of a risk-reporting system for operational risk.

(b) As part of the bank's internal operational risk assessment system, the bank must systematically track relevant operational risk data including material losses by

[1] "Internationally active bank" means banks operating in more that one jurisdiction or with clients from outside their place of incorporation. This will include almost all banks in the Crown Dependencies.

business line. Its operational risk assessment system must be closely integrated into the risk management processes of the bank. Its output must be an integral part of the process of monitoring and controlling the banks operational risk profile. For instance, this information must play a prominent role in risk reporting, management reporting, and risk analysis. The bank must have techniques for creating incentives to improve the management of operational risk throughout the firm.

(c) There must be regular reporting of operational risk exposures, including material operational losses, to business unit management, senior management, and to the board of directors. The bank must have procedures for taking appropriate action according to the information within the management reports.

(d) The bank's operational risk management system must be well documented. The bank must have a routine in place for ensuring compliance with a documented set of internal policies, controls and procedures concerning the operational risk management system, which must include policies for the treatment of non-compliance issues.

(e) The bank's operational risk management processes and assessment system must be subject to validation and regular independent review. These reviews must include both the activities of the business units and of the operational risk management function.

(f) The bank's operational risk assessment system (including the internal validation processes) must be subject to regular review by external specialists, auditors, and/or supervisors.

Schedule 2 – Qualifying Criteria – The Alternative Standardised Approach (“ASA”)

Qualifying criteria for all banks wishing to use the ASA

(a) In order to qualify for use of the ASA, a bank must satisfy the Commission that, at a minimum:

- Its board of directors and senior management, as appropriate, are actively involved in the oversight of the operational risk management framework;
- It has an operational risk management system that is conceptually sound and is implemented with integrity; and
- It has sufficient resources in the use of the approach in the major business lines as well as the control and audit areas.

(b) The Commission will have the right to insist on a period of initial monitoring of a bank’s ASA before it is used for regulatory capital purposes.

(c) A bank must develop specific policies and have documented criteria for separately identifying its aggregate mapping of its retail and commercial (loans) business lines from the gross income derived from the six other aggregated business lines book. The criteria must be reviewed and adjusted for new or changing business activities as appropriate. The principles for business line mapping relevant to the ASA are described in ***annex D***.

The Commission also recommends that banks which are not considered to be internationally active banks should nevertheless have due regard to the additional qualifying criteria stated below. The Commission will consider the additional criteria, taking into account the nature of a bank’s activities, when assessing whether a bank may qualify to adopt the ASA.

Additional qualifying criteria for internationally active banks[2]

An internationally active bank using the ASA must meet the following additional criteria:

(a) The bank must have an operational risk management system with clear responsibilities assigned to an operational risk management function. The operational risk management function is responsible for developing strategies to identify, assess, monitor and control/mitigate operational risk; for codifying firm-level policies and procedures concerning operational risk management and controls; for the design and implementation of the firm’s operational risk assessment methodology; and for the design and implementation of a risk-reporting system for operational risk.

(b) As part of the bank’s internal operational risk assessment system, the bank must systematically track relevant operational risk data including material losses by business line. Its operational risk assessment system must be closely integrated into

[2] “Internationally active bank” means banks operating in more that one jurisdiction or with clients from outside their place of incorporation. This will include almost all banks in the Crown Dependencies.

the risk management processes of the bank. Its output must be an integral part of the process of monitoring and controlling the bank's operational risk profile. For instance, this information must play a prominent role in risk reporting, management reporting, and risk analysis. The bank must have techniques for creating incentives to improve the management of operational risk throughout the firm.

(c) There must be regular reporting of operational risk exposures, including material operational losses, to business unit management, senior management, and to the board of directors. The bank must have procedures for taking appropriate action according to the information within the management reports.

(d) The bank's operational risk management system must be well documented. The bank must have a routine in place for ensuring compliance with a documented set of internal policies, controls and procedures concerning the operational risk management system, which must include policies for the treatment of non-compliance issues.

(e) The bank's operational risk management processes and assessment system must be subject to validation and regular independent review. These reviews must include both the activities of the business units and of the operational risk management function.

(f) The bank's operational risk assessment system (including the internal validation processes) must be subject to regular review by external auditors, specialists and/or supervisors.