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# Implementing an AMA for Operational Risk

May 20, 2005

Federal Reserve Bank of Boston

## AMA Implementation: Where We Are and Outstanding Questions

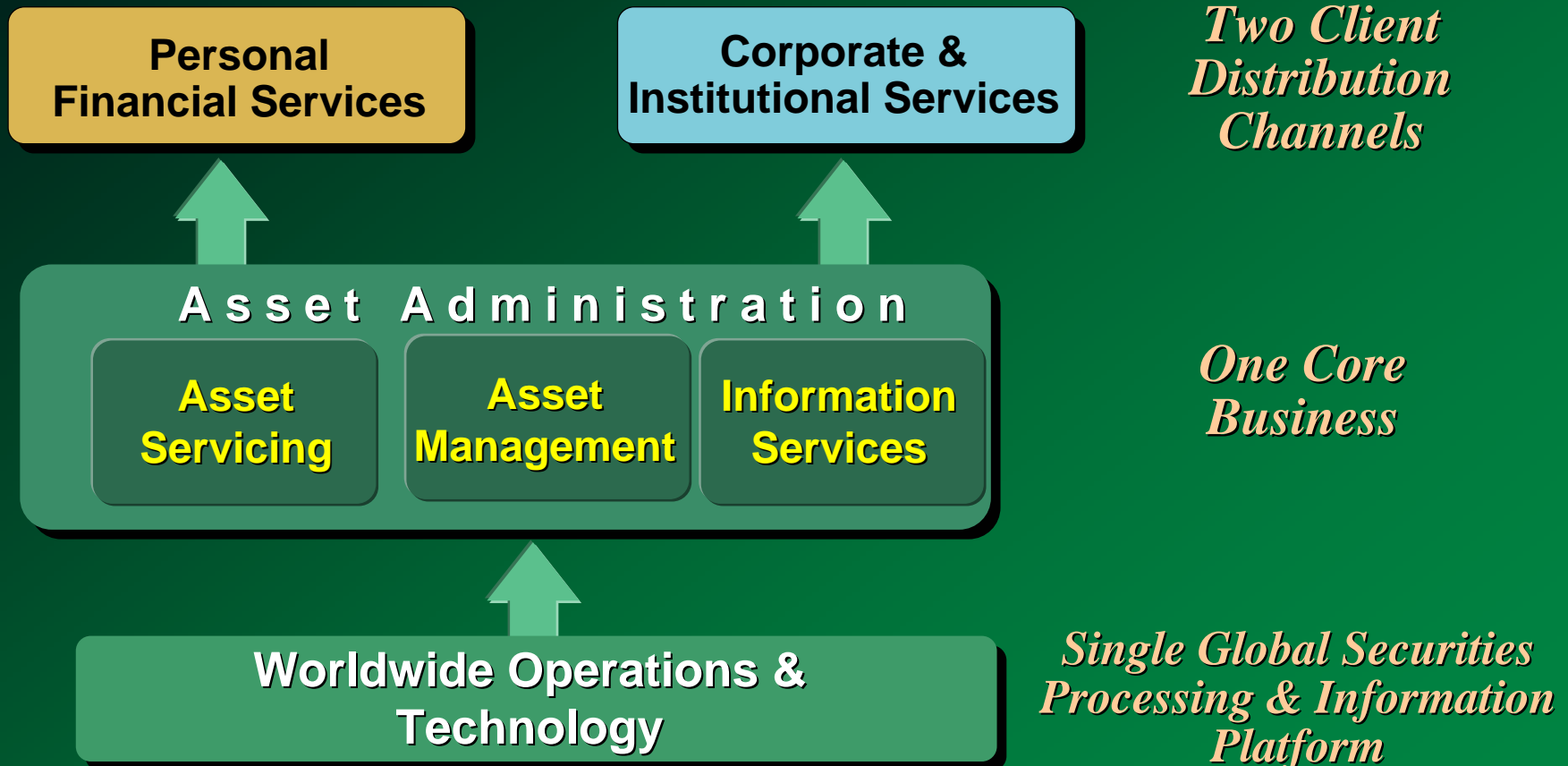
**Michael F. McGlinn**

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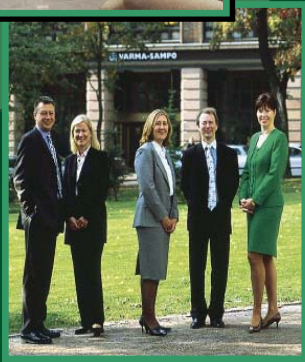
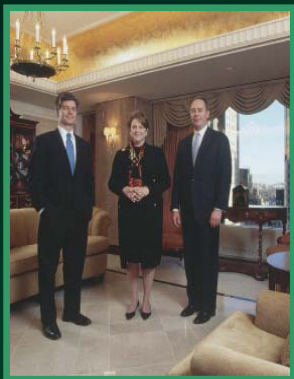
# A Consistent, Focused Strategy



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*Basel II - Operational Risk*

# Financial Performance Reflects Excellent Growth Trends



	Full Year 2004	% Change vs. Prior Year
Assets Under Administration	<b>\$2.6 Trillion</b>	<b>+23%</b>
Assets Under Management	<b>\$572 Billion</b>	<b>+19%</b>
Trust Fees	<b>\$1.3 Billion</b>	<b>+12%</b>
Total Revenues	<b>\$2.3 Billion</b>	<b>+9%</b>
Noninterest Expenses	<b>\$1.5 Billion</b>	<b>+5%</b>
Net Income	<b>\$506 Million</b>	<b>+25%</b>
	2004	2003
Fees / Revenues	<b>74%</b>	<b>72%</b>
Trust Fees / Revenues	<b>57%</b>	<b>55%</b>



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# Industry Leader in Serving the Affluent Market

**#1 Personal Trust Bank in U.S.**

Source: SNL Financial

**The Wealth Management Group**

The recognized leader in providing sophisticated financial solutions to high net worth families.

TARGET MARKET: Individuals or Families with \$75+ million in investable assets

**Wealth Advisory Services**

Delivering comprehensive, investment solutions through a multi-manager investment program.

TARGET MARKET: Individuals or Families with \$25 to \$75 million in investable assets

**Private Client Services**

Delivering high-touch trust, investment management and banking solutions to individuals through 83 offices in 17 states.

TARGET MARKET: Affluent Individuals with at least \$1 million in investable assets

\$1 Million

\$25 Million

\$75 Million

C L I E N T I N V E S T A B L E A S S E T S



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# Heritage and Commitment



1889

to

2005



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*We have a 116-year heritage - we have been Northern Trust since 1889 and are undiluted by mergers and acquisitions. The growth that we have achieved through the years has been overwhelmingly sourced from organic growth.*

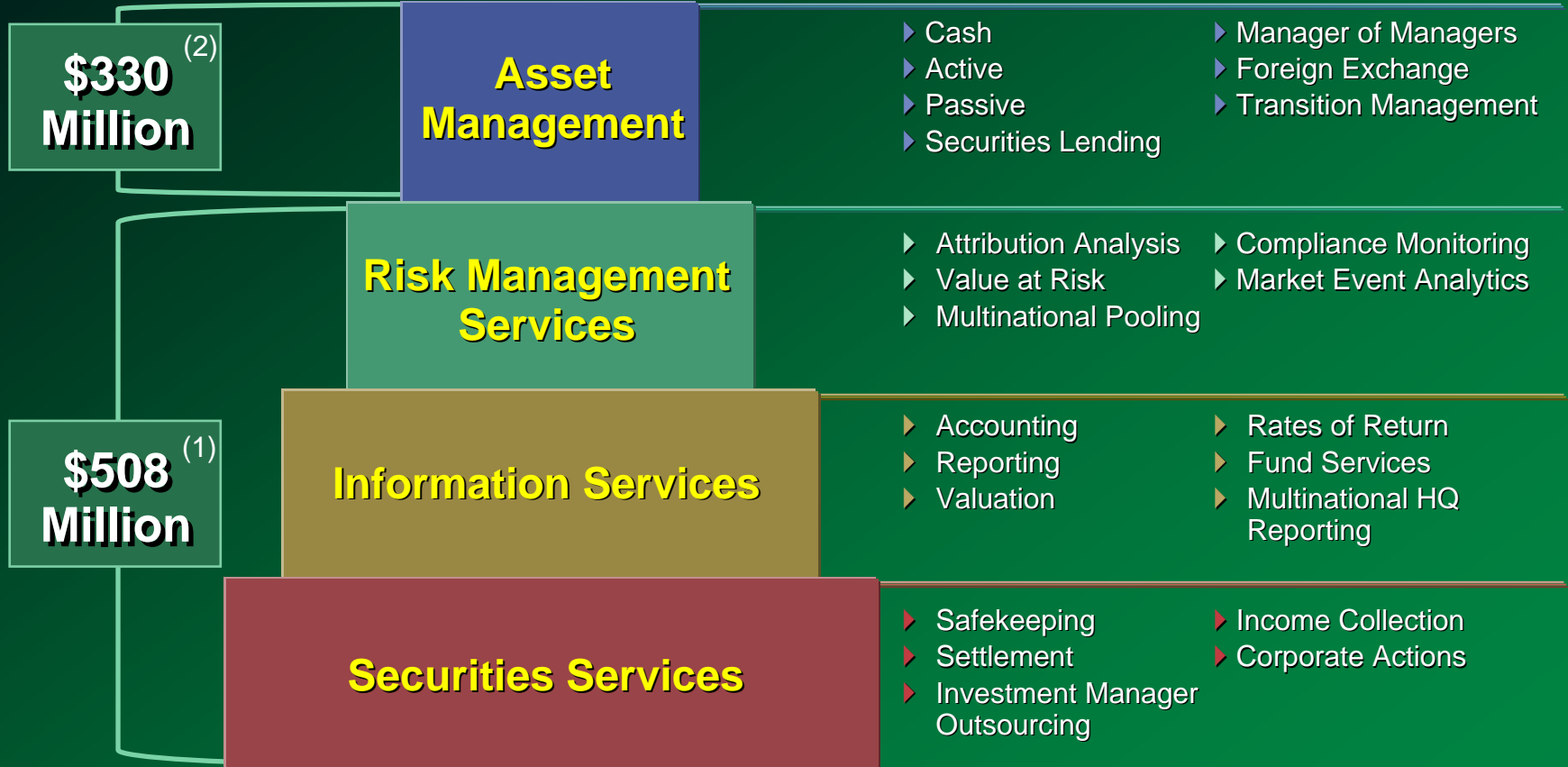


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# Positioned for Success and Profitability

## 2004 Fees



(1) - Includes fees relating to Custody Services and Other Services

(2) - Includes fees relating to Investment Management, Securities Lending and Foreign Exchange Trading



## *Spotlight:* **Recent Acquisition Announcement**

*Acquisition: Baring Asset Management's Financial Services Group*

- ◆ \$63 billion in fund administration assets, \$28 billion in custody assets, \$32 billion in trust assets
- ◆ 170 clients, 770 employees in 5 locations
- ◆ Enhanced product capability and expertise



# A Leading Investment Manager

- # 9 *Assets Under Management* <sup>(1)</sup>

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- # 8 *Worldwide Institutional Assets Under Management* <sup>(2)</sup>

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- # 4 *U.S. Tax-Exempt Assets* <sup>(2)</sup>

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- # 3 *Institutional Index Manager* <sup>(2)</sup>

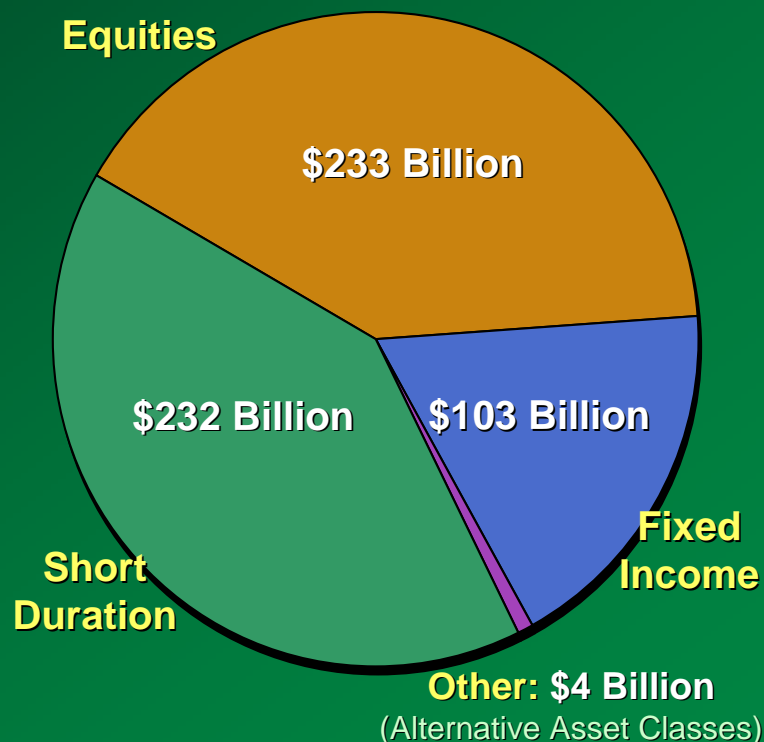
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- # 6 *Bank Run Mutual Fund Family* <sup>(3)</sup>

(1) *Global Investor Magazine - GI 100*  
(2) *Pensions & Investments*  
(3) *FRC, March 31, 2004, based on long-term funds*

RECORD  
Assets Under Management  
as of December 31, 2004

**\$572 Billion**





## Five Key Projects

- ◆ Qualification for the Advanced Measurement Approach (AMA) requires implementation of leading practices:

- 1. Operational Risk Management Policy**
- 2. Loss Event Data Collection**
- 3. Risk and Control Self-Assessment**
- 4. Structured Scenario Analysis**
- 5. Key Risk Indicator Identification & Collection**



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# Operational Risk Management Policy

- ◆ Define New Roles & Responsibilities
  - Senior Risk Management Officer (SRMO)
  - Corporate Operational Risk Group (CORG)
- ◆ Define New Governance Model
  - Corporate Operational Risk Council (CORC)
- ◆ Develop Common Language



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## Policy Issues

- ◆ Appropriate Level of Detail
- ◆ Shooting at a moving target
  - Do we describe future state or current state ?
- ◆ Consensus vs. Completion



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# Loss Event Data (LED) Collection

- ◆ 6 years of LED in Focus Database
  - Coded to Basel Risk Codes Level 1 & 2
  - Bedrock for QIS 4 Capital Modeling
- ◆ Transition to new Integrated Operational Risk Database
  - Many more fields to better use data
  - More natural interface for capital modeling
- ◆ Excellent starting point, basis for EVT modeling



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# LED Issues

- ◆ Legal
- ◆ Near Miss Events
- ◆ Integration of acquisitions



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# Risk and Control Self-Assessment

- ◆ Customize for each area:
  - Processes, Activities, Risks and Controls (PARC)
  - Quantify through scoring risks and controls (Frequency and Severity)
  
- ◆ Multi-tasking for the next several months
  - Software customization being done by vendor
  - Installation and testing to be done by Northern
  - Builds for each high priority area are underway
  - We will populate the system with RCSAs upon production status
  
- ◆ Institutionalizing the process is a 2<sup>nd</sup> half 2005 goal



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## RCSA Issues

- ◆ Legal
- ◆ Public Relations
- ◆ Capital Allocation
- ◆ QA – Consistency & Completeness



# Structured Scenario Analysis

- ◆ Required in Basel and Supervisory Standards
  - Benefit from experiences you haven't yet had
  - Better model capital with better estimate of tail events
  
- ◆ Pilot almost finished to develop approach
  - Facilitated sessions with 5 key areas
  - Learning curve to estimate possible frequencies and severities
  - Very positive feedback about value of the exercise
  
- ◆ Ongoing effort yet to be defined, depends on
  - Value to the business & to capital modeling exercise
    - Current thinking: Use scenario analysis output to construct an alternate tail
  - Direction from the Regulators





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# Structured Scenario Analysis Issues

- ◆ Clear Definition and Goals
- ◆ Comfort level estimating frequency and severity
- ◆ Potential Gaming
- ◆ Comfort with multiple modeling exercises involving alternate tail distributions



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# Key Risk Indicators (KRIs)

- ◆ Measures of important changes to the risk profile
  - Useful if they have predictive value
  - Unclear as to best practices in the industry
- ◆ Pilot is beginning to identify an approach
  - Facilitated introductory sessions
  - Trying to tie to ongoing metric work (Dashboard project)
  - Very open to industry and regulatory directions
- ◆ Unclear as to eventual role in effort



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## KRI Issues

- ◆ Thresholds – when does a KRI become really important ?
- ◆ KRI Correlations – What are the compounding effects when several KRIs crest at the same time



# Five Key Projects Issues

- ◆ How do we tie the projects together ?
- ◆ Where is it okay for them to be independent ?

- 1. Operational Risk Management Policy**
- 2. Loss Event Data Collection**
- 3. Risk and Control Self-Assessment**
- 4. Structured Scenario Analysis**
- 5. Key Risk Indicator Identification & Collection**





# *Summary & Questions*

*Thank You*

