Federal Financial Analytics, Inc.

FOR IMMEDIATE RELEASE

Contact: Matthew Shaw
mshaw@fedfin.com
202.589.0880

SIMPLE CAPITAL FOR COMPLEX OPERATIONAL RISK WEAKENS RESILIENCE, FEDFIN STUDY FINDS

Although often overlooked, operational risk is a major source of systemic risk, making operational-risk capital rules a critical plank in the post-crisis framework. A new FedFin paper concludes that revisions to the U.S. operational-risk capital regime along Basel's proposed lines would not raise more capital because large U.S. banks already hold more operational risk-based capital than other global banks. Basel's standardized approach would, however, significantly distort operational risk-taking incentives. The revised approach could thus make the U.S. financial system weaker under stresses such as cyber-attack and natural disaster.

WASHINGTON, DC, September 30, 2016 – In the wake of renewed attention in the U.S. to stress-test capital, attention has shifted away from pending global revisions to the capital charge now imposed on large U.S. banks covering operational risks such as cyber-security lapses, rogue trading, terrorist attacks, natural disasters, and even the huge regulatory penalties some banks still face years after the financial crisis. In a new study, Federal Financial Analytics, Inc. (FedFin) returns to the question of operational risk-based capital, showing how an overly-simple approach to regulatory capital could well make U.S. banks riskier even though capital requirements would not materially drop.

"Operational risk is fundamentally different from the credit risk on which global and U.S. regulators have long focused because more operational-risk capital doesn't create risk-reducing incentives – all it does is give banks a larger capital cushion with which to pay some of the costs of the risk after it materializes.

Better, of course, to stop the risk before a bank has to handle its cost," said FedFin managing partner Karen Shaw Petrou.

"Operational risk-based capital aligned with improved safety and soundness creates incentives to reduce risk – no capital charge no matter how high can prevent risks like natural disasters. What minimizes their impact isn't more capital, but rather resilient, redundant systems. When capital costs so much that banks skimp on resilience, risk gets worse and the financial system gets more fragile," Petrou concluded.

The Basel approach includes a standardized capital charge based on gross income – not risk. The study finds that this makes bank investment in operational risk-management and mitigation systems and the cost of risk buffers essentially worthless, forcing reliance solely on the ability of the regulatory assumptions built into the Basel rule to ensure that capital is correctly calculated. This study finds that U.S. banks now hold as much operational risk capital as Basel proposes, although the U.S. rules include risk-mitigation incentives that better align capital with risk. Standardized operational-risk capital therefore does not mean less operational risk. Indeed, it could well mean more operational risk since capital cannot be readily deployed to mitigate damage that occurs because mitigations were not put in place ahead of risk. The post-crisis reform goal of establishing a new, forward-looking, robust capital bulwark that ensures bank resilience and financial stability is thus undermined by standardized operational-risk based capital charges that do not anticipate forward-looking, bank-specific risk factors, the study concludes.

This paper was funded by The Clearing House Association. FedFin retained full editorial and methodological control over its content and conclusions and takes full responsibility for them.

####