Financial Services Management

Operational Risk-Based Capital

Cite

Basel Committee on Banking Supervision, Consultative Document, Standardized Measurement Approach for Operational Risk

Recommended Distribution:

CFO, Asset-Liability Management, Asset Management, Custody, Risk Management, Policy, Legal, Government Relations

Website

http://www.bis.org/bcbs/publ/d355.pdf

Impact Assessment

- ORBC will rise for most large U.S. banks and do so still more steeply for European ones.
- The re-proposed standardized ORBC charge continues to correlate higher capital with higher income based on Basel criteria even though it is disputable that operational risk is closely correlated with higher income.
- Banks that spend large sums to mitigate operational risk (e.g., through enhanced cyber-security, use of insurance) may not be credited for these costs due to the manner in which the standardized capital charge is measured.
- Banks with significant recent loss experiences (e.g., fines and settlements) will have high ORBC regardless of steps (many of them costly) to mitigate operational-risk drivers. Conversely, banks that did not experience such losses will have lower ORBC even though they may lack such mitigants and now be engaged in risky activities.
- Although nominally targeted to medium and large banks, the ORBC requirements ratchet up very quickly based on income. It is unclear that size correlates with operational risk.

©2016. Federal Financial Analytics, Inc.

- Loss data and calculation requirements demand extensive new MIS able to identify very small loss amounts that would require extensive new reporting systems, governance functions, and related infrastructure.

Overview

The Basel Committee has advanced action on its rewrite of the operational risk-based capital (ORBC) plans in the Basel III accord that were unchanged in 2010 from the ORBC requirements in the 2004 Basel II Accord.[1] Consistent with other Basel actions designed to standardize the global rules to enhance comparability and limit model reliance, the new ORBC proposal builds on an earlier consultation[2] to tighten these requirements in ways likely to raise the capital requirements for any large bank active in fee-based businesses and/or subject in recent years to significant legal and reputational risk. Fee-based businesses like asset management are major operations for many large banks – indeed tough credit- and market-risk capital rules have increased focus on fee-based businesses. However, they are also areas of vigorous non-bank competition that may well be strengthened as a result of these new capital requirements. As proposed, the new standardized framework would generally overlook operational-risk mitigation (including insurance), differing in this respect from other Basel rules that reward risk mitigation. Indeed, the calculation methodology could well penalize banks that have most heavily invested in risk mitigants, especially if they have done so in the wake of recent legal or reputational risk events. All but the smallest covered banks would need to build extensive management information systems (MIS) and related infrastructure in great detail down to very small loss levels that may be particularly costly for even medium-sized banks, let alone the largest ones.

Impact

Operational risk is not as large a capital driver as credit risk and, for banks with large trading positions, the new fundamental review of the trading book's requirements.[3] However, it is a significant capital charge for risks such as system failures, natural disasters, and legal and reputational risk likely to require most large banks to add some additional regulatory capital and to impose a significant additional capital cost on those banks that, based on their business model or recent history, are penalized under the proposal.

Although ORBC is not often seen as a major capital cost with a significant competitiveness impact, it is a strategic consideration for banks with large fee-based businesses that often include extensive profit derived from asset-management activities. Global and U.S. regulators have discussed imposing

---

[1] See **OPSRISK9**, *Financial Services Management,* July 28, 2004.

[2] See **OPSRISK16**, *Financial Services Management*, October 20, 2014.

[3] See **CAPITAL211**, *Financial Services Management*, January 26, 2016.

©2016. Federal Financial Analytics, Inc.

some sort of capital charge on non-bank asset managers, possibly in concert with designating some large firms as systemically-important financial institutions.[4] These standards are on hold following strong protests against them by asset managers, meaning that any higher capital requirements for banks will continue or even heighten competitive disparities. Asset managers dispute the need for capital on grounds that they are not like banks, but banks and some global regulators believe that like-kind activities should be regulated in comparable fashion in part because failure of a large asset manager could create significant systemic disruption or force taxpayer rescue.

The largest costs of the new approach will fall on those banks that have relied on the "advanced measurement approach" (AMA) option in the current ORBC framework. The new standardized requirements replace the AMA and limit the extent to which AMA-derived benefits have to date lowered regulatory capital totals. This replacement of a model-driven rule with a standardized one is consistent with Basel's overall objective of limiting risk-based capital variations based on national regimes and/or bank model-optimization efforts. As a result, it would improve comparability across banks and nations, but define ORBC on criteria that may well be at odds with a bank's actual operational-risk profile.

The AMA was developed because the income-based standardized measures in the Basel II approach were viewed by many not only as crude, but also as creating perverse incentives that essentially made the least profitable banks (and likely the riskiest ones) those bearing the lowest regulatory-capital cushion. The AMA corrected for this, but with models that regulators found generally reduced ORBC to levels they now believe to be too low and inconsistent. Banks generally found the AMA cumbersome and at odds often with their own risk models, but the prospect of returning to a standardized approach is not the cure many envisioned.

A key dispute sure to greet this consultation is whether the new standardized measurement approach (SMA) addresses this problem. Because the revised business-indicator (BI) that drives ORBC remains profit based (with loss not factoring into it), the new approach continues to correlate higher capital with higher profit even though actual risk correlation is at best uncertain. In the U.S., the FRB has already decided against using the loss-distribution method on which the AMA is premised for purposes of large-bank stress testing.[5] It is unlikely to work to preserve the AMA given this perspective.

The principal change in the new consultation from the 2014 one is revisions to the BI calculation to reflect individual bank loss indicators. This approach was vetted by Basel in a quantitative impact survey (QIS) it believes

---

4 See **SYSTEMIC75**, *Financial Services Management*, January 5, 2015 and **SIFI4**, *Financial Services Management*, March 12, 2015.

5 See **STRESS24**, *Financial Services Management*, January 28, 2016.

Federal Financial Analytics, Inc.
1140 Nineteenth Street, N.W., Washington, D.C. 20036
Phone: (202) 589-0880 Fax: (202) 589-0423
E-mail: info@fedfin.com Web Site: www.fedfin.com

© 2016. Federal Financial Analytics, Inc. All rights reserved.

validates the approach's parity and stability over time. However the revised BI essentially equilibrates operational risk with bank size even though it is at best uncertain if size and risk actually correlate as mechanistically as this consultation assumes. In addition, it poses an array of problems akin in some respects to those in the leverage capital rule – while ORBC under the SMA is standardized and relatively transparent, it is nonetheless often divorced from risk despite the addition for larger banks of the loss indicators.

This is not only because the income drivers in the business indicator are reached irrespective of risk and in some cases even reward risk taken when banks are experiencing lower profitability and seek to enhance it by skimping on operational-risk infrastructure and mitigation. The new approach also may dissociate capital from risk because the loss-indicator component is retrospective and thus punishes banks that incurred operational losses during the crisis that may well have significantly improved operational-risk resilience and compliance. Conversely, this approach rewards banks that did not err before but could now be incurring considerable amounts of unmitigated operational risk that neither the business indicator nor loss component captures.

Banks have historically sought to mitigate operational risk (OR) through an array of reserves, governance and compliance protocols, as well as system redundancy and resilience. Reserves may be captured in the BI methodology to some extent, but the proposal generally bars recognition of all the others. This may in part be because these mitigants are difficult to quantify (e.g., a corporate culture that encourages compliance), but most are quite costly. Because mitigants are excluded from the SMA's approach means that ORBC is not in fact sensitive to risk mitigation and incentives in the SMA may in fact encourage greater risk-taking.

In addition, banks often use insurance to address OR such as those resulting from natural disasters, system failures, rogue traders, human error, and legal risk. Although not discussed in this consultation, global regulators have long doubted the actual ability of insurance to pay claims and thus limited its recognition in the initial Basel II AMA. In concert with terminating the AMA, insurance recognition would be ended, creating a disincentive for its use because banks essentially would pay twice for loss mitigation – once through insurance and again in the ORBC requirement. In contrast, the credit- and trading-book requirements permit a wide array of mitigants, including the functional equivalent of insurance provided through certain derivatives.

What's Next

This consultation was released on March 4th with comments due by June 3rd. The consultation indicates that Basel will proscribe the timeline for terminating the AMA and introducing the new SMA in 2016, when Basel will also undertake a new QIS.

©2016. Federal Financial Analytics, Inc.

Analysis

A. Business Indicators

As in 2014, the business-indicator (BI) ORBC driver consists of P&L factors that generally drive gross income (GI). However, only positive values are used so that Basel does not apply what it calls a counter-intuitive result in which income-losing activities are still assigned a capital charge. However, as noted, the capital charge is thus positively correlated with profit even though it is unclear if more profitable banks run more operational risk. Risk is usually seen as correlated with loss, which may be particularly true when operational risk mitigation requires sunk infrastructure costs that may be skimped under earnings pressure. Although omitting most negative GI inputs, the BI reverses some – e.g., operating expenses – to make them positive BI factors based on the view that these expenses include operating losses that are a risk driver.

Other adjustments in the proposal aim to correct problems in the 2014 consultation to avoid unduly punitive charges on banks with an originate-to-distribute model, standardize the dividend-related calculations, and increase ORBC for banks with high net interest margins (NIMs) and high fee income based on the view that robust NIMs and fee-based revenue mask operational risk. The new consultation also normalizes the treatment of leasing versus loan income to ensure that ORBC is consistent across these income streams.

BI would be calculated on three-year averages of the requisite components. Capital charges are computed based on the Basel QIS's findings about industry averages, which banks divided into five "buckets" segregated by size in which the BI drives ORBC based on these components and, in some cases, the loss indicator described below. ORBC does not increase proportionately because the operational risk rises disproportionately to the BI based on the bank's size.

B. Loss Indicators

This measure is designed to capture operational risk for banks with comparable BI values. The Loss Indicator is derived from a bank's own internal-loss experience interpolated through an internal-loss multiplier included that adds higher ORBC when banks have had large-tail losses (i.e., approximately $10 million) during the past ten years. The framework requires banks to amass ten years of "good-quality" internal-loss data (see below) and then adjust them by the size of the loss and other factors. At the start of the process, banks that lack ten years of eligible data may use five years.

Where the BI and loss component are the same, the BI sets the SAM's capital requirement; when the loss component is greater or less than the BI, ORBC also adjusts up or down. Basel's QIS leads it to believe this approach leads to a stable ORBC requirement, but it also lays out an alternative approach on which comment is solicited. It is also concerned about the treatment of extreme-loss events.

© 2016. Federal Financial Analytics, Inc. All rights reserved.

Qualitative standards in the consultation define eligible data to prevent gaming with regard to loss-indicator calculations. To ensure this, the consultation would not only require compliance with its standards, but also impose a multiplier on any bank with significant losses to ensure that its reported losses are still not under-estimated. The consultation details how data are to be gathered, what they must cover, and how they are to be validated, creating a significant new set of MIS requirements. A *de minimis* reporting threshold of about $11,500 would govern the level of detail these systems would need to track, a level many large banks will think surprisingly small for capital purposes. The small threshold combined with the types of data otherwise required suggest that supervisors would use these filings not only to judge ORBC, but also operational risk-management systems.

Confusion between which losses are to be reported in the banking book may ensue because the consultation says that some (e.g., collateral-management failures) should be treated as credit risk, not operational risk covered by these protocols and capital. In contrast, it appears that all operational risks in the trading book are covered.

Among the data elements banks are to gather are gross and net losses based on insurance coverage. Despite this, insurance is not considered a mitigant for purposes of SMA calculation.

©2016. Federal Financial Analytics, Inc.