Financial Services Management

Global Operational Risk-Based Capital Standards

Cite

Basel Committee on Banking Supervision, Minimum Capital Requirements for Operational Risk

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Impact Assessment

- Basel's new ORBC standards are in many respects blind to risk, essentially mandating a leverage-ratio style capital standard for operational risk.
- This approach permits greater international comparability and a basic minimum requirement, but may be insufficient for higher-risk banks and unduly costly for others based on business model or risk profile.
- Banks with asset management, trading, or similar activities with large operational-risk exposures may or may not face high ORBC charges based on how the Basel model affects actual risk. If they do, this will adversely affect competitiveness with non-bank firms with large operations in these non-traditional banking businesses.
- Retroactive ORBC-risk setting is likely to overlook emerging risks at individual institutions and across the financial system.

Overview

In conjunction with changes to the leverage ratio,[1] a new standardized approach (SA) for credit risk,[2] and revisions to the internal-ratings based approach along with a new "output floor,"[3] the Basel Committee has finalized a proposed approach[4] to the operational risk-based capital (ORBC) standards in the Basel II rules. These track the overall new approach in all of the other "Basel IV" actions in

[1] See **LEVERAGE11**, *Financial Services Management*, December 13, 2017.

[2] See **CAPITAL221**, *Financial Services Management*, January 2, 2018.

[3] See **CAPITAL222**, *Financial Services Management*, January 4, 2018.

[4] See **OPSRISK18**, *Financial Services Management*, March 17 2016.

that they circumscribe reliance on internal models – here called the "advanced measurement approach" (AMA) – in favor of supervisory-dictated risk weightings or, for operational risk, a set of quantitative indicators and percentages that determine applicable capital. The new operational-risk approach directly ties ORBC to a bank's size and earnings, tempered to the extent a supervisor wishes by historical-loss experience that can raise or lower the basic amount of ORBC mandated by the income-based approach. This policy thus may force large, profitable banks to hold more ORBC even if their loss experience does not indicate significant risk and/or if prior risky practices have been remedied. Conversely, lower-profit banks may have reduced ORBC even if their risk profile warrants a more stringent approach.

Impact

Conceptually, the new approach assumes that operational risk increases largely in lockstep with a bank's income or retrospective losses. In practice, this is rarely true, as FedFin's in-depth assessment of Basel's consultation made clear.[5] Indeed, banks with sufficient income may well be more likely to invest in operational-risk mitigations (e.g., redundant systems or insurance), costs skimped by a more stretched bank hoping to gain an advantage by aggressive pricing or other profit-generating strategies.

Further, the components used in the business-indicator approach to calculating the ORBC base may well have little to do with operational risk or conversely could be far more linked to it. For example, a bank with very large asset-management operations will be recompensed for a business in which its risk is principally operational in largely the same way a bank with large amounts of interest income from lending might be assessed. Similarly, a bank that invests heavily in non-financial operational-risk mitigation (e.g., strict internal controls) will be judged largely the same as a far more casually managed bank. Differences in businesses that require different types of operational-risk mitigation at far different costs are also not recognized, likely distorting risk-mitigation incentives.

Indeed, the new approach does not generally permit capital offsets for loss mitigation, as is now done in the netted approach long used for credit and market risk. The final Basel standards do permit greater recognition of insurance as a loss mitigant, but only in terms of counting historical-loss experience (where insurance recoveries may be used to reduce gross losses). To the extent a bank has large losses offset by large recoveries, its ORBC charge will be reduced on a going-forward basis versus a bank with comparable losses that lacked comparable insurance. However, a bank that bought insurance and then never experienced a loss or loss recovery would have no offset to its gross-loss exposures. Because operational risk is often "fat-tail" – i.e., low-frequency, high severity, Basel's approach also creates disincentives for structural operational-risk mitigation and encourages entry with insufficient up-front risk-mitigation investment into new markets or businesses.

Because operational risk is often qualitative and due to external factors even harder to model than those germane to credit and market risk, the new approach essentially applies a single number to a wide variety of actual operational-risk profiles.

[5] See FedFin Paper: *Capital's Cast-Off: Operational Risk-Based Capital and Its Critical Implications*, **http://www.fedfin.com/info-services/issues-in-focus?task=weblink.go&id=299**.

The final formulas are altered somewhat from the consultation to capture some of these differences, but proposed requirements – i.e., a surcharge on banks with large fee-based business models – that would have truly differentiated ORBC by business model has also been dropped. In essence, banks will pay an ORBC tax starting at twelve percent of the rule's income calculation largely regardless of their actual operational-risk profile.

To correct for this at least to some extent, Basel's final standards assume that banks that in the past experienced operational-risk losses are more likely to do so in the future. However, this assumption is also uncertain based on post-crisis experience. Many banks that experienced severe legal and reputational risk due to events such as residential-mortgage failings are now among the world's most conservative lenders, often also eschewing securitization altogether outside of government-backed channels to the secondary market. These penalized lenders have been replaced with new entrants, many of them outside the scope of any capital requirements in the U.S. Although the credit-risk cycle is at its most benign in recent years, several of these new entrants are already facing enforcement penalties that threaten franchise value in part due to the lack of ORBC buffers to absorb emerging risks.

Reflecting all these worries in Basel's prior standardized ORBC options, the U.S. did not follow the Basel II approach,[6] instead implementing only the AMA for the banks over $250 billion in assets otherwise required to use the advanced approach to credit risk.[7] As a result, U.S. banks generally hold considerably more ORBC than their international cohorts. If the U.S. maintains the AMA (which the Basel standards does not expressly allow), U.S. banks would likely still hold considerably more ORBC than peer-group competitors especially in business lines well captured by the AMA with unduly-low RBC under the new standardized measurement approach. If the U.S. abandons the AMA, then ORBC would track global requirements, at least for banks, but systemic risk would rise based on the concerns described above.

What's Next

The Basel Committee and its governing body finalized the ORBC rules in concert with the other changes noted above on December 7, 2017. The implementation date is January 1, 2022. A forthcoming consultation will address new disclosure requirements.

The U.S. Congress has advanced legislation[8] that will complicate U.S. adherence to this Basel approach unless U.S. regulators use Basel-granted flexibility and omit the historical-loss factor sanctioned in the legislation. The measure passed the House as part of the Choice Act and House FinServ then reported a similar stand-

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

[7] See **CAPITAL201**, *Financial Services Management*, July 19, 2013.

[8] See **CAPITAL215**, *Financial Services Management*, June 16, 2017.

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alone measure in a 43-17 vote on November 15. It is not included in the financial-reform legislation reported by the Senate Banking Committee.[9]

Analysis

A. Scope

ORBC standards continue to apply only to internationally-active banks, although national supervisors may apply them more broadly. The standard applies on a fully consolidated basis, netting across the group and on a stand-alone basis for each subsidiary, with adjustments made if the subsidiary lacks necessary high-quality loss data.

As before, operational risk is the result of losses not attributable to credit or market risk or to interest-rate, duration, counterparty, and other risks addressed in an array of Basel standards. Instead, operational risk derives from factors such as human or manmade disasters, systems failures, fraud, and legal risk.

B. Standardized Measurement Approach

The operational-risk SMA is based on a Business Indicator (BI) (a financial-statement-based proxy for operational risk) and the Business Indicator Component (BIC), calculated by multiplying the BI by a set of regulatory determined marginal coefficients, the Internal Loss Multiplier (ILM) scaling factor based on a bank's average historical losses over the past ten years and the BIC. Historical-loss data must meet qualitative standards proscribed in the Basel agreement, with banks that do not yet have enough high-quality data allowed to use only five years of loss data or even less as they transition to the new approach unless they have been using the AMA.

Specifically, the BI has three components calculated in accordance with various formulas in the final standards on a three-year rolling average. They are:

- interest, leases, and dividends (omitting a capital surcharge proposed for banks with significant fee- – not interest- margin – based business models);
- services; and
- financial factors.

The following income and related factors are excluded from the BI components:

- insurance and reinsurance income;
- premiums paid or reimbursement received related to insurance and reinsurance;
- administrative expenses and related recoveries;
- fixed-asset expenses unless these are related to operational risk;
- provisions and reversals other than when germane to operational risk;

[9] See *Client Report* **SIFI25**, December 6, 2017.

- asset impairment or reversals;
- goodwill changes; and
- tax payments.

Generally, the larger the BI (i.e., the bigger the bank), the higher the ORBC capital requirement. When historical-loss experience is used, the BI-determined factor is then multiplied by a formula that generally increases ORBC according to the amount of loss. Conversely, banks with low-loss histories in comparison with their BIC can reduce ORBC vis-à-vis what would otherwise have been required under the BIC-based calculation.

C. ILM Components and Qualitative requirements

As noted, the ILM approach includes extensive standards governing how internal-loss experience is to be measured over the past ten years for relevant subsidiaries calculating the ORBC requirement and on a consolidated basis across the BHC or banking organization. Banks that do not have enough high-quality data must generally hold at least the minimum amount of ORBC calculated by the above methodology – i.e., without any discount for a low-loss operation. If national discretion omits the ILM from the applicable ORBC regime, internal-loss history would nonetheless need to be disclosed by each covered banking organization.

This section of the final standards has been significantly revised from the prior approach to define operational losses more stringently (i.e., including relevant attorney's fees and other indirect costs) and to allow considerably greater netting based on operational-risk mitigation and insurance recoveries after receipt of payment. *De minimus* thresholds have also been made more generous.

The final standards also give supervisors greater flexibility with regard to forward-looking aspects of the ILM. Unlike the current U.S. approach, supervisors may now choose to allow a bank to delete from its historical-loss experience the losses associated with lines of business or operations the bank no longer owns or conducts. Still, Basel cautions that any such exceptions should be "rare" and viewed with considerable supervisory skepticism. Conversely, banks must include historical-loss experience in their own BI following merger or acquisition.

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