



Federal Financial Analytics, Inc.

OPERATIONAL RISK REALITY VERSUS OPERATIONAL RISK REGULATION

The pandemic, U.S. wildfires, Citibank's woes, new AI tools in custody banking, and fast-paced fintech advances are only some of the events redefining operational risk. Capital, resilience, and governance rules will get a revamp when regulators address all these hard lessons.

The analytics below are based on in-depth reports provided to FedFin clients.
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On September 11, we were soberly reminded of the critical importance operational risk plays generating financial crises. As a [note](#) sent then to FedFin clients detailed, the Fed's intervention that day in 2001 was the largest on record up to that point, precipitated by destruction of the global payment system's hub buried beneath the Twin Towers. Regulators turned to resilience regulation after 2001 and Basel II's rules in the mid-2000s also included new operational risk-based capital standards.

The great financial crisis (GFC) in 2008 was all about credit and liquidity risk, obscuring the importance of operational risk and leaving it largely overlooked ever since. However, what many are now calling GFC-2 – COVID's systemic scourge – is all about operational risk. At the same time, climate change – another operational risk – is wreaking havoc across the globe even as financial-service products, delivery, and core infrastructures are rapidly redefined. Citibank's \$900 million loan-payment debacle is old-school operational risk, but clearly this too hasn't gone away.

Given all this, what are regulators doing about operational risk? First, [global capital rules](#) remain retrospective, meaning that banks under Basel's new standards were capitalized to buffer risks such as those evident when U.S. banks failed to properly service residential mortgages almost a decade ago. The U.S. hasn't adopted Basel's approach, but [still demands that the largest banks](#) adhere to the advanced measurement approach despite widely acknowledged modelling and stress-testing concerns. Global regulators have weighed in with forward-looking [resilience standards](#) that run counter to the capital construct, adding also a new proposal for complex [operational-risk governance](#) rules. [As FedFin told clients](#), these will add more boxes for risk managers to check, but whether risk is actually reduced is very much TBD. For starters, failure to anticipate insurance and reinsurance coverage capacity has been a longstanding weakness of the framework, but it's of even more critical importance in the wake of recent events.

Instead of these patchwork updates, operational-risk rules will change significantly and even structurally in the wake of so many operationally-derived systemic risks. If regulators simply recalibrate the operational-risk capital rules, they may alleviate its retrospective flaws, but, absent more structural change, these rules would also accelerate asset management's transformation into a nonbank-dominated sector. Climate risk is also forcing [widespread action](#) on stress testing, [regulatory capital](#), and supervision not just for banks, but across the financial system.

It remains to be seen if the new operational-risk framework is comprised mostly of one-off enforcement actions and capital hikes, a more comprehensive framework, or a wholly new one aimed at hot risks such as climate change. FedFin clients will receive both analytical updates and forecasts of critical developments; to learn more, reply by return email.

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