Operational Risk-Based Capital Standards

Cite

FDIC, FRB, OCC, Notice of Proposed Rulemaking, Regulatory Capital Rule: Amendments Applicable to Large Banking Organizations and to Banking Organizations With Significant Trading Activity

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Website

https://www.fdic.gov/news/board-matters/2023/2023-07-27-notice-dis-a-fr.pdf

Impact Assessment

- ORBC charges will be particularly costly, especially to banks with significant fee-based income and category III/IV banks that will for the first time become subject to an express capital charge.
- Higher ORBC charges may create incentives for reduced operational-risk mitigation via costly insurance, redundant facilities, and internal controls as ORBC capital is not meaningfully offset by risk mitigation.
- Banks may face particularly acute competitive challenges from nonbanks if their business models (e.g., custody, asset management, trading commissions, consumer-transaction fees) are significant revenue components.
- It is unclear if operational resilience will be substantively redressed with the new capital charge, based as it is on retrospective indicators.

Overview

Noting that operational risk is present at all banks due to most activities, the U.S. regulatory-capital rewrite would end the current approach to operational risk-based capital (ORBC).[1] This now subjects only categories I and II banks to ORBC and then only to the advanced measurement approach (AMA) premised on each bank's internal models. Consistent with the overall decision to end internal-model reliance,[2] this section of the proposal subjects categories I, II, III, and IV banks to a new operational-risk standardized approach (SA). This would result in very steep capital requirements based on a bank's experience over the past ten years compared to various sources of revenue over the past three years, perhaps taking business-model changes over the course of the last three years into account if regulatory standards are met for doing so. Steps banks have taken to prepare and avoid operational risk and respond to prior incidents are also generally not captured in a meaningful ORBC adjustment. As a result, ORBC capital standards may be premised on risks the bank is now unlikely to encounter on a go-forward basis or offsetting

[1] See **OPSRISK14**, *Financial Services Management*, June 14, 2011.

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

the costs essential to preventing and absorbing the operational risks it now might encounter.

Impact

The agencies have dispensed with the AMA not only because they have decided to eschew models in general, but also because they have found the AMA to be a challenging way to measure operational risk that introduces considerable capital-planning uncertainty. However, as noted, key aspects of the new approach judge operational risk on retrospective indicators that may reflect different operational-risk conditions (e.g., repeat disaster or cyber-attack) unlikely to occur in the coming year and/or business activities that have been or will be significantly changed in comparison to the retrospective three-year rolling averages on which a key measure is generally judged. The new SA could still ensure the certainty the agencies seek, but it is far from clear if it certain capital standards will calculate and thus capitalize operational risk any better than banks have been able to do setting ORBC based on their findings and supervisory input. Indeed, given that banks now have at least some capital incentives under the AMA and many via best practices and bank supervision, the rule's largely-academic methodology may reduce organizational resilience and slow recovery.

When formulating the Basel III standards in 2013, the banking agencies decided to retain Basel II's AMA because that approach – only somewhat modified in the new Basel standards[3] – failed to reflect bank-by-bank variations in matters such as internal-control quality that in turn have meaningful impact on each bank's vulnerability to operational risks such as fraud and costly litigation. The location of bank premises and the nature of their operations also has material impact on natural-disaster risk that could not then and is unlikely now to be captured in the proposed SA for these and other operational risks.

The new operational-risk charges are among the proposal's costliest because of these changes to the AMA and the reach of the ORBC standard to categories III and IV banks. FRB Gov. Waller noted in his vote opposing the new approach that operational-risk expense/loss projections in the most recent stress test are $200 billion; the Fed's impact analysis suggests $2 trillion of operational-risk assets for purposes of calculating the output floor.[4] Mr. Waller estimates that this could double current ORBC charges for affected banks.

As Mr. Waller also noted, it is unclear if higher ORBC will ensure additional resilience. First, as noted, the standard's retrospective methodology makes it a most uncertain platform from which to forecast future risks. Notably, none of the other proposal's standards are retrospective, judging banks instead on the credit,[5] equity/securitization,[6] and market[7] risk banks hold at the time capital is calculated based on assessments of future loss under a range of possible future borrower and market conditions. It is most unclear why this approach is inapplicable to operational risk, with the agencies' explanation – the difficulty of future quantifications in this arena – in turn suggesting that regulatory capital may not only be an ineffective way to buffer risk, but even a perverse one given the importance of costly insurance, internal controls, redundant facilities, and effective governance to operational-risk prevention. Operational-risk mitigation may indeed be costly (e.g., legal fines, new facilities), but insurance and other mitigants not

[3] See **OPSRISK20**, *Financial Services Management*, January 8, 2018.

[4] See forthcoming *FedFin report*.

[5] See **CAPITAL231**, *Financial Services Management*, August 4, 2023.

[6] See **CAPITAL232**, *Financial Services Management*, August 8, 2023.

[7] See forthcoming *FedFin report*.

recognized in the capital scheme are likely to be significant buffers in concert with better preparedness and controls.

Large banks are also subject to capital buffers above and beyond those in the minimum standards, including excess capital for severely-adverse scenarios related to credit and market risk that do not adversely affect operational resilience or, conversely, increase operational risk without concomitant, adverse impact on a bank's other exposures.

What's Next

The capital standards were approved on a 4-2 vote by the Federal Reserve Board, a 3-2 vote by the FDIC board, and the Acting Comptroller of the Currency on July 27. Comment is due November 30. The new rules will be phased in beginning on July 1, 2025 until June 30, 2028. A similar three-year phase-in is detailed for categories III and IV banks with regard to AOCI recognition.

In addition to these standards, the agencies will issue new disclosure requirements. They will also modify rules affected by the new approach to regulatory capital, including via the GSIB modification proposed in concert with this proposal.[8] Other affected rules revised by this proposal govern TLAC[9] and single-counterparty exposures, eliminating reliance on internal models.[10] The Board in 2019 also issued a long-delayed proposal governing the capital of depository institution holding companies with significant insurance operations.[11] Any final rule will reflect the new capital regime, with no time indicated for how long it may take the Board to do so once these rules are finalized. Thus, as has long been the case, these insurance-focused companies remain subject to significant uncertainty about parent-company capital standards but avert the top-down, bank-focused approach the Board once favored.

Analysis

A. Business Indicator (BI)

1. Components

Intended as a measure of the activities in which a bank engages, the BI attempts to quantify business volume and would be mostly based on three-year rolling averages of the sum of:

- interest, leases, and dividends. Net interest income would be capped at 2.5 percent of interest-earning assets;
- gross fees, commissions, and other income resulting from transaction accounts, interchange fees, late fees, and similar revenues and similar "services." The agencies believe that netting this income source would distort operational-risk exposures, although it is possible that it also penalizes activities with low

8 See forthcoming *FedFin report.*

9 See **TLAC6**, *Financial Services Management,* December 21, 2016.

10 See **CONCENTRATION11**, *Financial Services Management*, June 25, 2018.

11 See **INSURANCE60**, *Financial Services Management,* September 17, 2019.

expenses that might also be less risky. Component also includes any other operating income and well as operating losses across the banking organization; and

- financial factors (e.g., net trading income, unrealized gains/loss, net securitization/asset-sale income). Income taxes and certain other expenses are also excluded.

Numerous expense factors (e.g., personnel) are excluded from the BI unless they result in operational loss.

Each of these components is defined in careful detail. The proposal states that these components signal both size and complexity, but it is possible that a bank's BI may largely consist of only one component or only a few business activities within one or more components. As a result, the BI appears more an indicator of size rather than the complexity said to be key to a heightened operational-risk profile. The preamble also says that size and complexity are likely to give rise to control gaps, but why this is more likely than at some smaller companies subject to, for example, significant litigation risk is not made clear.

Further, as noted, the use of retrospective three-year averages to compute the BI may reflect prior business volumes no longer applicable at the company on a go-forward basis. However, activities that a bank has ceased to conduct may be excluded from the retrospective BI calculation if the relevant losses are at least five percent of annual total net operating losses and the primary regulator approves the exclusion after demonstration by the bank that past activities pose no legacy exposures.

2. Scaling factors

BIs over $1 billion would rise twelve percent, fifteen percent for BIs between $1 billion and $30 billion, and eighteen percent over $30 billion following a method detailed in the NPR. This is also based on the view that size signals operational risk.

Further, ORBC would be higher for banks that have experienced larger operational losses in the past. The internal-loss multiplier would scale capital based on the ratio of annual total net operational losses (not counting insurance receivables) to its BIs. This multiplier could be no less than 1, with regulators able to increase the multiplier regardless of formulas if they think it insufficient. The multiplier goes up to a formulaic maximum described as a limited approach to operational-risk recognition based on the prior ten years in order to reduce volatility. The NPR also addresses how these calculations are to be done in the event of acquisition, divestiture, or incomplete data.

Here, it should be noted that the NPR redefines operational losses not only to include those in traditional areas, but also any related to financial-statement revisions affecting capital, with loss defined as all expenses other than opportunity costs and that related to internal repair/improvement, with a $200,000 materiality threshold. Various reporting and calculation requirements designed to group and account for operational losses are also detailed.

3. Questions

Questions are posed on:

- how the services component is measured, with particular attention to whether separate treatment for activities such as charge-card income, wealth management, underwriting, or custody is warranted;
- the multiplier floor of 1; and
- the treatment of merged or acquired businesses.

B. Operational-Risk Management and Data Collection

1. Data

Extensive data-collection requirements are proposed along with detailed processes to ensure accuracy validated by independent review. Qualitative data on the nature of bank's operational risk would also be required, but AMA-related data requirements would end along with the AMA.

2. Risk Management

However, consistent with the AMA, banks would also need discrete, independent operational-risk management function governing all the requisite data along with risk management. Risk-controls processes, procedures, and analysis would also be required subject to governance by senior management and the board.

Questions here address the operational-risk driver data requirement.

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