Federal Financial Analytics, Inc.

**Basel Operational Risk Proposal High-Risk, Not Inevitable, Petrou Says**

"Perhaps some of you agree with me about the problems with a Pillar 1 operational risk-based capital charge, but are nevertheless plugging ahead on it. You may be doing this because you think, regardless of the rights or wrongs, operational risk-based capital is inevitable. Perhaps I'm overly optimistic, but I think the debate over Pillar 1 is far from settled. Regulators will tell you it is, but Members of Congress are taking a quite different approach."

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WASHINGTON, D.C. – In remarks today before the Operational Risk Management Forum, Federal Financial Analytics' managing partner Karen Shaw Petrou outlined an array of ongoing problems with the proposed capital charge for operational risk. Ms. Petrou has testified numerous times to this effect before Congress, and her remarks today make clear that none of the changes that might be made in the proposal address its fundamental problems. The Basel II framework and the U.S. rules that implement it would mandate a new operational risk-based capital (ORBC) requirement, mandating some form of capital calculation for risks like those related to systems failure, natural disasters or even 9/11.

"I think much in the ORBC proposal detracts from the urgent work dedicated to the first set of critical operational-risk tasks. Indeed, I think the Basel capital charge may create

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perverse incentives against effective operational risk management at a time when global threats and natural disasters of late remind us how important this challenge remains." Ms. Petrou continued, "Right now, though, the biggest hurricane blowing on the financial industry comes from New York Attorney General Eliot Spitzer's formidable trumpet. The Basel II formulation omits reputational risk from operational risk, a dubious call in my view, because rep-risk can – and lately surely does – have far more franchise-busting power than the ops-risk criteria detailed so painstakingly in Basel II."

Ms. Petrou's speech details three types of problems with the ORBC proposal: technical ones (no one has yet agreed on how to measure operational risk), perverse incentives (diversion of essential resources from effective operational risk mitigation), and competitive concerns. Many banks now overlook these in hopes that the ORBC proposal will be offset by drops in credit regulatory capital. However, banks with big books of mortgage servicing or credit-card receivables could find that ORBC would hit them far harder than now anticipated. It remains, of course, a serious problem for specialized banks that must compete with non-banking institutions outside the Basel framework in the United States.

Ms. Petrou's speech is attached.

*Federal Financial Analytics, Inc. has for the past eighteen years counseled large financial institutions and even their regulators on major legislative, regulatory and policy issues that pose strategic risk. It does not lobby on behalf of clients, but advises them on appropriate responses in light of identified challenges, working on an array of GSE, Basel II, and acquisition-value issues. The firm publishes numerous information and analytical services, including Financial Services Management and GSE Activity Report.*

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