The Should-We Threshold to Operational Risk-Based Capital: Policy Problems with the Basel II Proposal

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At this conference, all of you are rightly spending time and effort on improving operational risk identification, assessment, management and mitigation. There's no question that operational risk management is critical to ensure safety and soundness, as well as to insulate investors from unnecessary surprises. However, we have another topic before us today: the Basel II operational risk-based capital proposal and the U.S. rules to implement it. I think much in that 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 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.

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-buster power than the ops-risk criteria detailed so painstakingly in Basel II and the U.S. agency proposals. Reputational risk is, I believe, as subject to disciplined risk management as the other operational risk pieces before us. Its omission from the Basel II framework thus creates another troublesome perverse incentive: the diversion of resources necessary to comply with Basel II will leave the rep-risk front unguarded at all too many financial services firms. Whirring away on all the models required under Basel II could well distract from the more systemic change that effective risk management requires here. I should also remind you that interest rate risk is, and will remain, in Pillar 2.

Thus, today I would like to turn from the "how to" comply with the Basel II operational risk-based capital charge questions to a more threshold one: should you have to do this now? One of the reasons bank regulators use in defense of the capital charge is that it creates strong incentives for all the "how to" work on which you are all engaged. I think regulators – especially U.S. ones – have more than ample resources to encourage you to do what they want, when they want it. Would all of you working on SR 99-18 raise your hands? That's proof of pretty darn good incentives, I think. Comparable guidance on broader ops-risk and rep-risk issues would lead to measurable advances in risk management and mitigation, without the offsetting problems created by the capital charge.

Now, 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. If you haven't yet read them, take a look at the comment letter on the ANPR filed by Chairman Oxley, Rep. Frank and the leadership of the House Financial Services Committee as well as an additional one sent this year. Both take a strong stand against a Pillar 1 operational risk charge, with the ANPR comment letter specifically saying, "Our concern is that a Pillar I capital charge could result in restrictions in risk mitigation efforts. We urge the U.S. federal regulators to rely on Pillar II for operational risk regulatory capital, while encouraging banks to enhance both their critical infrastructure protection systems and their operational risk management systems." Indeed!

As I think through the operational risk-based capital (ORBC) proposal in Basel II, its problems fall into three broad categories: problems within the proposal, the perverse incentives it creates and the adverse competitive impact it could have. Let me now briefly summarize each of these issues.

Technical Trouble

Time doesn't permit a detailed discussion of the technical problems remaining in the advanced measurement approach (AMA). This revision to the initial Basel proposal is, to be sure, miles away from the basic-indicator and standardized approaches. Their reliance on gross income as a measure of risk was, is and will be a bad way to assign regulatory capital. Gross income has nothing to do with risk – in fact, when it's down, risk often is up. U.S. concession to an ORBC charge based on purported improvement in the AMA has allowed Basel to keep the gross-income approach in place, and this will, we think, have serious systemic implications for a global financial system where some of the banks using these options are far from small.

However, back to the AMA. Some key concerns include:

- The rule would count both expected loss (EL) and unexpected loss (UL) towards the ORBC charge. Why? Basel II rightly has decided to focus solely on UL on the credit risk side, even though banks have a profit incentive to take this risk and minimize reserves. That incentive generally doesn't apply to operational risk, making the UL approach even more appropriate in this arena. Moreover, historically operational losses have been more than amply covered by the ongoing earnings stream.

- There simply isn't enough data over a long enough period of time on ops-risk on which anyone can rely. Individual institutions now are just beginning to improve their own internal data bases, with the U.S. regulators moving forward on an industry-wide loss data collection exercise to see who's got what and how well it can be extrapolated. No regulatory capital charge should be based on data that remain years away from a collective best guess.

- Much of the attention so far has focused on specialized lines of business – asset management, custody, etc. – where the ORBC charge is a big hit. However, regulators also plan to impose ORBC on assets like mortgage servicing rights. How? The risk here is a combination of system error and legal/regulatory problems. The first risk may be quantifiable, but the second surely isn't.

- Indeed, the legal risk problem extends far beyond these retail assets. Why should there be a capital charge for it at all? U.S. banks must allocate reserves when legal risk is quantified, and these reserves are fully disclosed. Also, U.S. banks are subject to types of legal risk that are unknown to many outside the U.S. which can be a significant competitive disadvantage to U.S. banks.

- The AMA still takes scant account of risk mitigation, especially insurance. The data exercises to date show insurance as a remarkably good offset to ops-risk, and it's hard to understand why this form of risk mitigation is so much less reliable than the credit risk mitigation in which Basel II takes great stock.

One final thought: given all these problems, how will supervisors judge your AMA models and performance? My guess: for at least a few years, AMA will be benchmarked against the standardized approach. Thus, each of you will need to organize your ops-risk approach on business lines that may well not comport at all with how your banks are organized and the charges could be based on – guess what – gross income.

I remain deeply puzzled why, in light of all these reservations – not to mention the policy ones I'll discuss in a minute – Basel II decided on a Pillar 1 approach for operational risk, while leaving interest-rate risk in Pillar 2.

Perverse Incentives

As I mentioned, the problems with a Pillar 1 ORBC charge go beyond the seemingly technical ones on definition, measurement and mitigation. Fundamentally, a capital charge will be costly, and this cost will create a disincentive for investments in proven forms of operational risk mitigation. Frankly, I've yet to see an operational risk incident in which the Pillar 1 charge would have been of much use –

- 9/11? I don't think so. What counted then – other than heroism and ingenuity in the face of evil – were disaster preparedness and contingency planning. Would ORBC have stepped in to support the payments system when a major clearing institution found that its telecommunications infrastructure crumbled? The capital might have offset some of the rebuilding cost – which the industry bore remarkably well in part due to insurance – but it would have had no impact on the ground at that critical time.

- Barings? This is the case most frequently cited by bank regulators as the justification for a Pillar 1 ORBC charge. However, what would have blocked Nick Leeson was a simple double-check on his records – basic ops-risk management, of course, is not letting traders tell you just how great they're doing. ORBC is no offset to criminal fraud, but its cost can lead banks – some already prone to err on the side of insufficient internal controls – to neglect critical internal protection. Regulators may also be over-casual when an ORBC charge substitutes for effective risk management. Regulators will tell us that this won't happen, but they will be so stressed here and abroad that it easily could.

- Reputational risk? How to quantify Eliot Spitzer?

- Hurricanes? Earthquakes? Has one in modern times ever caused a bank to fail? Of course not – in large part because of all the risk mitigation that Basel II discounts in favor of the ORBC capital charge.

The Franchise-Buster

If you're still feeling good about ORBC, I have one final argument against it: the Pillar 1 capital charge poses a serious risk to an array of banks that compete against non-banks and specialized institutions that compete against diversified ones. Of late, some at the Federal Reserve have argued that regulatory capital will have no competitive impact, but I strongly disagree. If it doesn't, why has all the work gone into getting Basel II right on so intricate a line-of-business basis? The entire rationale for Basel II is regulatory arbitrage – defined at the outset by regulators, including senior ones from the Fed, as the impact of differences between regulatory and economic capital that cause banks to go in or out of different business or asset types. Is regulatory capital the be-all and end-all of franchise value? No, all other things held even. But, it's hard to hold everything else even all the time, and this makes regulatory capital a key element in competitiveness.

In the EU, ORBC will apply to all financial institutions. In the U.S., it won't. First, the U.S. proposal would "bifurcate" risk-based capital. Thus, smaller institutions could stay out of Basel and the ORBC charge. Secondly, non-banks are major players in a lot of specialized business lines – asset management, payments processing, for example – where ORBC will hit hard. The SEC has recently imposed a Basel-like capital charge for some of the biggest investment banks, but major differences between it and the banking proposal mean much of the competitive impact on banks remains unaddressed. Further, a lot of competitors – non-bank mutual funds or mortgage companies, for example – don't come under the SEC rules and so have no ORBC charge at all. Do the ratings agencies impose something like it? Not as far as I can see.

When regulatory capital diverges from economic capital, it has a particularly acute competitive impact on institutions that specialize in affected business lines. A diversified bank can absorb an undue regulatory cost if its overall regulatory capital requirement allows this to be handled without undue total ROE impact. In essence, cuts in credit risk can cross-subsidize a hike in ORBC, especially if the diversified institution sees cross-selling opportunities or other synergies with the specialized activity. Should regulators necessarily care if business lines are conducted in specialized or diversified businesses? In general, this should be a market – not a regulatory – decision. However, regulatory capital standards should be neutral with regard to this critical question, especially given the growing risks associated with consolidation and the concomitant concentration of financial assets in a few hands.

Conclusion

Let me stop where I started. Regulators will concede many, and sometimes even all, of the problems I've raised. Their one remaining defense: ORBC builds strong ops-risk incentives. It reminds me a lot of the old Wonder Bread ad – that was supposed to build "strong bodies twelve ways." In fact, of course, it tended to make our young bodies pudgy because the more of it we ate, the less good fiber we got. If we divert all the resources – already hard-pressed by Basel II's other demands and the critical importance of improving operational and reputational risk management – to a Pillar 1 capital charge, we will deprive the financial system of essential nutrients.

In short, I don't think an operational risk-based capital charge is a good idea, and therefore I hope it isn't an inevitability. With a different hat on, I am working to replace a Pillar 1 charge with a credible, enforceable Pillar 2 backed up by additional Pillar 3 disclosures. This approach will do a good deal more for financial stability and effective economic capital allocation, while reducing the competitive concerns I and many others have, than a Pillar 1 charge. For now, Pillar 1 ORBC isn't ready for prime time.