BANK POLICY INSTITUTE

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Operational Risk Issue Summary

Banks manage different types of risk, like the credit risk of non-repayment to loans they've made or credit they've extended. They also manage so-called "operational risks," which include losses related to inadequate or failed internal processes, people and systems, or from external events. Unlike credit risk, however, operational risk is inherently subjective, making it more difficult to measure. Because it is exceedingly difficult to base a capital charge on a subjective assessment of the risk inherent in a bank's operations, these models generally look at past losses and treat them as a proxy for the risk of something going wrong in the future. Large banks are required to build and maintain models to measure their operational risk based on a Federal Reserve-approved Advanced Measurement Approach (AMA). Operational risk capital currently accounts for approximately 28% of the largest U.S. banks' risk-weighted assets, or the equivalent to four times the amount of capital banks must hold against their trading activities.

BPI's Position

Operational risk requirements should be based primarily on the risks posed by a banking organization's current activities and businesses, not simply businesses that created losses in the past. They should recognize and encourage risk mitigation, by adjusting for qualifying actions that insure against loss.

Recommendation: The broken AMA requirements should be replaced with the new international standardized measurement approach (SMA) immediately. A switch to the SMA standard will ensure that operational risk capital charges are more reasonable, predictable and forward-looking.

Existing Model Broken

The current advanced measurement approach (AMA) for operational risk capital requires banks to develop an internal model that looks at both internal and external historical loss data to estimate operational risk. This approach to operational risk capital is flawed and unreliable, inherently backward-looking, and produced widely varying and highly volatile estimates. As a result, banks currently hold operational risk capital in amounts well in excess of the worst possible operational risk losses. Recognizing this flaw, the Basel Committee recently rewrote the rule book, putting in place a new standardized measurement approach (SMA) system that, while imperfect, is simpler and better than the AMA.

Not Linked to Actual Risk

U.S. banks are often prohibited from excluding losses from their models even when the bank has exited the business line that caused the loss or sold the business to another institution. Similarly, banks may put in place a range of adjustments to mitigate risk, such as insurance or hedges, but none of these are meaningfully recognized or reflected in the current operational risk capital framework. Finally, for some banks, regulators add a "supervisory overlay" to any modeled results, which is an arbitrary add-on, with no analytical or evidentiary basis. As a result of these factors, operational risk capital charges are inflated and extremely sensitive to any data anomalies or extreme events.

Adopting a forward-looking operational risk capital requirement focused on a bank's current activities and businesses would ensure that banks are holding capital more efficiently and expanding credit to meet consumers' needs.