Basel III Endgame Operational Risk Requirements: The $1.4 Trillion Tax

FINANCIAL SERVICES FORUM

Proposed operational risk capital requirements would negatively impact the whole economy.

Federal regulators have proposed an increase in capital requirements. A critical aspect of the proposal – operational risk capital requirements – would affect the cost and availability of all financial products and services provided by large banks, including lending, securities underwriting, and asset management services.

What is Operational Risk?

Like all companies, banks are exposed to operational risks such as sustaining damage to bank branches from a severe hurricane.

Currently, **banks manage and capitalize their operational risks through ongoing risk management and a risk-sensitive, model-based approach** that considers actual operational risk losses that have occurred over time.

Operational Risk Capital Requirements Under the Proposal

Under the proposal, the current risk-sensitive, model-based approach would be replaced by a completely new standardized capital charge. **The new operational risk capital requirements account for 78% of the total increase in required capital.**

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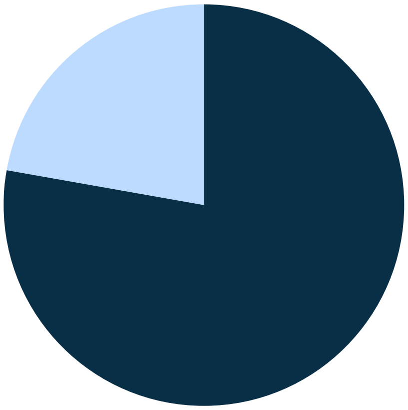

Operational risk capital is a tax on all banking activities and would be applied widely, impacting the cost and availability of every financial service provided by the largest U.S. banks, including:

- **Lending to small businesses**
- **Bond underwriting for state and local government**
- **Providing mutual fund offerings for retirees, and all other services**

Operational Risk and the Stress Tests

Operational risks are already accounted for in the Federal Reserve's stress tests, **making the additional requirements in the capital proposal duplicative.**

Three Key Technical Problems with the Proposed Requirements

1. Crude Financial Measures of Size are not a Useful Proxy for Operational Risk

The proposal measures operational risk using several **financial measures of "size" that bear no substantive relation to operational risks, including** the absolute value of the amount of trading revenue generated by a bank. A higher amount of trading revenue would lead to a higher amount of required operational risk capital.

However, an increase in trading revenue has nothing to do with operational risk, but rather signals an increase in financial risk that is already capitalized through other requirements.

2. Proposed Measures of Operational Risk are not Internally Consistent

After the financial crisis, many large banks took steps to increase their footprint in service-oriented bank businesses such as asset and wealth management because they were an excellent source of diversification and risk reduction. **These new operational risk requirements would penalize these successful efforts to diversify risks.**

In the proposal, service-oriented bank businesses would be measured for operational risk on a gross basis with respect to the maximum of revenues and costs and would be considered riskier than other businesses such as direct lending, where operational risks would be largely measured on a net basis with respect to net interest income. As a result, **banks' incentives to diversify into steady, fee-generating businesses that do not take significant financial risks would be measurably diminished by higher capital requirements unrelated to actual operational risks.**

3. Interest-generating Activities are Subject to a Cap while Fee-based Activities are not

The proposal's interest, lease and dividend component is subject to a cap equal to 2.25% of the bank's interest income-generating assets. However, there is no similar cap for the services component. This disparate treatment of interest income-generating and fee-generating business lines has **perverse incentive effects and is not driven by any substantive assessment of differential operational risks.**

The Bottom Line:

There is no clear or compelling evidence to suggest that operational risks present a concern commensurate with a $1.4 trillion dollar increase in risk weighted assets that would represent the key driver of increased large bank capital requirements.

For specific questions on the capital proposal, please contact **capital@fsforum.com**.