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**Statement of the Shadow Financial Regulatory Committee**

**On**

**The Basel 2 Approach to Bank Operational Risk: Regulation on the Wrong Track**

**May 6, 2002**

Over the past year the Basel Committee on Banking Supervision has refined its approach to setting minimum capital requirements for operational risk (see "Regulatory Treatment of Operational Risk" in September 2001, "Sound Practices for the Management and Supervision of Operational Risk" in December 2001, and a "Quantitative Impact Study for Operational Risk: Overview of Individual Loss Data and Lesson Learned" in January 2002). The result is a revised definition of operational risk, a reduced target for capital charges for operational risk relative to total minimum capital requirements and greater specificity about how such capital charges might be implemented. The Shadow Committee believes this attempt to set capital charges for operational risk is fundamentally misguided.

The Basel Committee began in 1998 by using a definition of operational risk as all risk that is neither credit risk nor market risk, and this is the definition that US regulatory authorities have also used in supervisory releases. The Basel Committee has now narrowed this very broad definition to include only "the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events." This definition itself raises several issues. First, it omits altogether basic business risk: the risk of loss attributable to the institution's inability to reduce costs as quickly as revenues decline. It also excludes the Basel Committee's earlier attempt to include indirect costs and reputational risk. Second, it conflates two different species of risk subject to two different sorts of managerial incentives. Institutions try to balance market and credit risk against expected returns, whereas operational risk is a kind of expense that they try to minimize to the extent that it is cost effective to do so. The two different species of risk are best dealt with, the Shadow Committee believes, in two different ways,

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as we indicate in the conclusion.

The Basel Committee hopes that by imposing a risk-sensitive capital requirement for operational risk it will lead institutions to enhance the measurement and management of operational risk and will discourage them from substituting operational risk for credit or market risk. The Basel Committee has stated a goal to set capital charges for operational risk in conjunction with an anticipated reduction in the capital charge for market risk, so that overall capital charges will remain the same on average. This goal dictates their charge for whatever measure of operational risk they devise and belies any claim that the capital charge with regard to operational risk is somehow objectively determined.

The Shadow Committee questions whether there is a compelling rationale for setting a capital charge for operational risk and, more importantly, whether the Basel 2 approach is the most efficient means of achieving a reduction in the exposure of institutions to operational risk. Losses due to operational risk tend to be idiosyncratic to a particular institution and therefore not a source of systemic risk. The sorts of institution-destroying operational losses that have occurred – often due to the actions of a rogue trader – are usually attributable to a failure of internal controls rather than inadequate capital. No reasonable account of capital would be sufficient to cover such an extreme event. The most effective means of reducing operational risk are sound policies, practices and procedures, and insurance (which also serves the function of shifting losses should they, nonetheless, occur).

The Basel Committee has identified three approaches to setting capital charges for operational risk: (1) The Basic Indicator Approach, (2) The Standardized Approach and (3) The Advanced Measurement Approaches. Each approach requires a greater investment in processes and procedures than the one that precedes it on this list. The Basel Committee intends to provide an incentive for institutions to make the investment by calibrating the approaches so that the capital charge will be lower if an institution qualifies for the more complex approach.

The Basic Indicator Approach will set the charge for operational risk as a percentage of Gross Income, defined to include net interest income and net non-interest income, but excluding extraordinary or irregular items. While this variable may crudely capture the scale of an institution's operations, it surely has only the most tenuous link to the risk of an expected loss due to internal or external events.

The Standardized Approach requires that the institution partition its operations into eight different lines of business. The capital charge is then estimated as an exposure indicator for each line of business multiplied by a coefficient. Provisionally, the Basel Committee intends to use Gross Income for this purpose as well. Its quantitative impact study attempted to examine actual losses across these eight lines of business experienced by thirty banks in eleven countries from 1998 to 2000. These losses, however, do not necessarily reflect differences in risk. First, frequent small losses, because they are predictable, tend to be expensed. They do not contribute to the risk for which capital is held. Second, the loss data did not reflect recoveries and indemnification from insurance.

The Advanced Measurement Approaches require multiple pages of preconditions that most institutions could not be expected to meet for years. Reflecting the Basel Committee's uncertainty about the best way to proceed, it outlined three different approaches. The Basel Committee is willing to consider insurance as a mitigator of operational risk only under the Advanced Measurement Approaches and only to the extent that it does not reduce the capital charge below 75 percent of the capital charge computed under the Standardized Approach.

Neither the Basic Indicator nor the Standardized Approach provides a persuasive way of relating the capital charge for operational risk to actual differences in operational risk across institutions, and the Advanced Measurement Approaches remain to be fully specified. Clearly in this instance, the desire to make capital regulation risk sensitive has exceeded the Basel Committee's capacity to implement it.

It is unclear why the Basel Committee insists on dealing with operational risk under Pillar 1 – that is, as an issue of capital adequacy. Interest rate risk in the banking book, which is surely easier to quantify than operational risk, is dealt with only under Pillar 2 – that is, as a supervisory issue. And Pillar 2 is surely the most efficient way of dealing with operational risk. Appropriate policies, procedures and processes are the most direct way of dealing with internal events, and insurance is the most effective way of dealing with external events. These are the sorts of issues that are best dealt with in the supervisory process rather than through an extended but essentially arbitrary exercise in capital regulation. The Basel Committee clearly intends to proceed along the supervisory line as well, but with a one-way ratchet. Supervisors will be able only to impose an additional capital charge if they find that policies, processes and procedures are inadequate, but not to reduce the capital charge for institutions that have exemplary controls. Since the Pillar 1 capital charge is already imperfectly risk sensitive, the Basel 2 approach that feeds operational risk into Pillar 1 may end up only distorting competition further.