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Executive Director

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Basel Committee Secretariat
Basel Committee on Banking Supervision
Bank for International Settlement
CH-4002
Basel, Switzerland

Dear Sir or Madam:

I am writing on behalf of the Financial Guardian Group to raise serious reservations with regard to the operational risk-based capital provisions included in the proposed revisions to the Basel capital accord. The Financial Guardian Group has been organized to represent the views of those U.S. financial services firms — principally banks — that believe strongly that a capital charge for operational risk is ill-advised. As shall be discussed in more detail below, we respectfully urge the Committee on Banking Supervision to drop the idea of a specific capital charge for operational risk and instead incorporate this risk into Pillar 2, as has been done for interest-rate risk.

Because the Financial Guardian Group is still in formation, it is not possible at this time to provide you with a complete list of our members. I look forward to doing so shortly, as well as to providing you with additional comments on the proposed rule and a detailed alternative based on the supervisory approach referenced above. Group members include some of the world's largest custodian banks, as well as those with major asset management and payments processing businesses. As such, we have a keen interest in the operational risk-based capital (ORBC) rule, which will have a profound impact on member companies. For such firms, the ORBC charge will not be just an add-on to credit risk-based capital — although that too would be objectionable. Instead, an arbitrary capital cost will be superimposed on activities already well protected through economic capital, reserves, insurance, internal controls and other forms of risk mitigation.

As shall be discussed in more detail below, the Financial Guardian Group believes that an ORBC capital charge could have the perverse result of actually increasing the riskiness of the global financial system because it will create an incentive for asset management, custody and payment services to migrate from banks to far less well-regulated entities. Further, the rules, in essence, are a regulatory tax on investors because they will impose a disproportionate charge on a wide range of services necessary to support individual and institutional investment. As such, the rule could have an unintended macroeconomic impact, especially in countries like the U.S. with low savings rates.

In this letter, we shall provide more detail on our policy concerns with the regulation. We also recognize that the Committee has asked certain banks for quantitative assessments in connection with a separate request. However, that request does not permit respondents to calculate the potential impact of the proposal on a coherent line-of-business basis based on the so-called "beta factors" and other information provided in Annex 3 in the detailed operational risk-based proposal. The FGG believes that the quantitative survey will not provide the Committee with an accurate or forward-looking assessment of the ORBC proposal.

Executive Summary

The Financial Guardian Group wishes to bring the following major concerns with regard to the operational risk-based capital charge to the attention of the Basel Committee:

- We are unaware of any instance, other than the collapse of Barings, in which poor management of operational risk was a predicate cause of a bank's failure. We believe the supervisory approach would more than adequately address the failings in the Barings case, as well as in any potential problems elsewhere. We are puzzled as to why the Committee has proposed a quantitative approach to operational risk, while declining quantitative approaches for interest-rate risk or the other risks that can be quantified more readily.

- The proposed ORBC charge is at significant variance with the amount of economic capital necessary to address operational risk, and it fails to account for the important role of reserves in protecting capital against a risk that is almost always covered through operating income. As a result, the proposal will cause the same type of regulatory arbitrage the Committee is now seeking to cure through the changes to the credit risk-based capital (RBC) rules. Institutions will engage in higher-risk activities, including shedding insurance or ceasing to out-source certain services, because risk mitigation receives no capital credit. Some institutions will abandon their bank charters, increasing systemic risk.

- Imposition of a separate ORBC charge on banking institutions that retain their charters will make such institutions less competitive in the market place for asset management and custody services. These competitive pressures will factor into decisions to de-bank, as noted above, and contribute to systemic risk by moving these activities outside the more regulated banking arena.

- The ORBC charge is a tax on investors. Banks will be forced to pass some or all of the costs associated with the charge on asset management and custody services to their individual and institutional customers. This will significantly reduce the effective rate of return, lowering national savings rates and decreasing capital formation.

- The proposal will result in significant international inequities because of the major differences in legal regimes in which banks operate. U.S. banks will suffer because the capital charge will be an additional one imposed on their risk related to employment discrimination, fair lending, disability rights and many other areas not considered problematic in other nations. At the same time, the proposal does not capture in a capital

charge the significant infrastructure risks associated with poor electrical or telephone service in some nations. The U.S. supervisors already capture legal, compliance and reputation risk in their supervisory framework, while other nations have yet to do so.

- Technical fixes will not salvage the proposal. Operational risk should be addressed solely through Pillar 2 supervisory measures.

I. Alternative Proposal

The Financial Guardian Group respectfully recommends that the Committee revisit the concept of including operational risk in Pillar 1. We believe that the Pillar 2 supervisory approach is a far more appropriate framework for addressing any concern the Committee may have about operational risk. We note that operational risk is handled through gains or losses in operating income, not through charges to capital, under all but the most extraordinary circumstances. As a result, a supervisory, not capital, approach is desirable.

We note that the Committee has reaffirmed its decision not to impose a specific capital charge on interest-rate risk (IRR). However, IRR is far better understood and more easily quantified than operational risk. Indeed, literally trillions of dollars are traded each year in the interest-rate swap market based on well-established models of IRR. Any well-managed institution has extensive IRR models in place, and supervisors have had ample opportunity to review these to determine a specific methodology for establishing a global capital scheme. Yet, the Committee has not done so, preferring instead to rely on bank management processes and supervisory assessments of IRR. If a specific capital charge is not viable for IRR, then it certainly is inconsistent now to impose one for operational risk.

Both the Committee and domestic regulators have been similarly reluctant to establish quantitative capital charges for other risks, even though some of these can be more readily quantified than operational risk. For example, U.S. regulators are required by law to establish capital standards for concentration risk. They have chosen to do so through broad guidelines supplemented by on-going supervision — a Pillar 2 approach.

The U.S. regulators have also adopted a Pillar 2 approach for the risk associated with non-traditional activities, again responding to a legal mandate to impose some form of capital charge for this risk. The Committee has also eschewed a specific capital charge for “conglomerate” risk, a companion concept to the U.S. mandate. The regulators have rightly chosen a Pillar 2 approach for conglomerate risk, recognizing that a specific quantitative charge could stifle innovation and create perverse incentives for charter arbitrage.

Indeed, U.S. regulations point to a wide range of risks that are captured through the supervisory approach, rather than in an explicit capital charge. At 12 CFR 325, the U.S. capital regulation stipulates that the following risks should be included by institutions in their overall capitalization without imposing a specific charge for them: overall interest-rate risk; liquidity; funding and market risk; the quality and level of earnings; investment, loan, portfolio and other concentrations of risk; certain risks arising from non-traditional activities; the effectiveness of loan and investment

policies; and management's ability to monitor and control risk. Clearly, explicit capital charges for all of these would create a burdensome and rigid capital framework with many unintended consequences. Regulators should use the same forbearance with regard to operational risk that has so far governed the capitalization of the many other risks banks routinely manage.

As shall be discussed in more detail below, the ORBC charge creates at least as many problems as the now-rejected quantitative charges for IRR, concentration, conglomerate and other risks. ORBC is not quantified in any standard model and there are no industry-accepted definitions for it, in contrast to both IRR and concentration risk. Further, many banks involved in some of the lines of business most adversely affected by the ORBC proposal compete head-to-head with non-banks that will not be covered by the capital requirement. As was feared in the conglomerate risk proposal, some could select to shed their banking charters and move into less well-regulated charters to avoid an onerous capital charge that bears no relation to economic capital requirements.

The Financial Guardian Group will be providing the regulators with specific recommendations about Pillar 2 approaches to operational risk. We believe these will more than adequately address the concerns behind the capital proposal, providing a better framework from which to address operational risk.

II. Policy Concerns

We believe that a specific capital charge for operational risk will have numerous adverse policy implications, as well as raise profound technical problems. In this section of our comment, we address the major policy issues raised by the proposed ORBC charge. The next section will cover technical concerns.

To put our policy concerns into context, the Financial Guardian Group estimated the ORBC charge for several major U.S. banks using the basic indicator approach, as well as using estimated midpoint betas for asset management and retail banking in the standardized approach. ORBC charges for custody services could not be estimated because no beta factor has been specified, but we believe it would add significantly to the ORBC required under the models. While our analysis generated pro forma estimates only, the results highlighted the severity of the ORBC charge for institutions significantly involved in asset management and custody services. In several cases, the ORBC charge for asset management alone — assuming a beta of 50 basis points — was two to three times the charge using the basic indicator. These estimates highlight the severe calibration problems with the proposed ORBC approach, as well as its sharp divergence from economic capital and market assessments of the riskiness of these institutions.

A. Operational Risk Does Not Lead to Bank Failures

The Financial Guardian Group is aware of only one bank — Barings — which has failed in modern financial markets because of poor management of operational risk. Were the regulators to adopt a capital standard to capture each and every credit, concentration, IRR and mismanagement event that has caused bank failure in the past thirty years, it would build a capital construct of such complexity and cost that no bank could profitably operate.

In the Barings case, it is clear that serious control failures and legal violations caused the bank's collapse. Pillar 2 supervisory requirements would adequately address the control issues involved in Barings, many of which were serious transgressions of existing Bank of England requirements. In cases where there is willful intent to deceive, no amount of capital can adequately protect an institution and its depositors.

The Financial Guardian Group does not believe it is possible to impose a capital standard aimed at protecting against the risks of legal violations by employees or outsiders. Effective supervision of conscientious management is the most reliable method of preventing legal violations, while no amount of capital is likely to be sufficient to offset the impact of grave problems overlooked in the management and supervisory process.

B. The Proposed Charges Bear No Relation to Economic Capital

The Financial Guardian Group recognizes that the Basel Committee is seeking quantitative information on operational RBC through its QIS 1 and QIS 2 surveys. However, we do not believe that either of these instruments will provide the Committee with meaningful data.

The QIS 1 survey asks only for overall economic capital, without any breakdown for specific operational-related economic capital. We understand that the Committee had previously sought to survey banks to obtain economic capital data, but found many institutions either unable to respond or only able to provide company-wide data, as requested in the QIS 1. The QIS 2 attempts to capture line of business data, but maps business lines into operational risk categories that do not accurately reflect actual corporate structures. As a result, the QIS 2 data will do little to improve the ORBC calibration.

Without any validated empirical foundation, the Committee has nonetheless proposed to calibrate ORBC at either 30% of gross income under the basic indicator approach or 20% of the total amount of credit RBC required in the standardized model. We have calculated these numbers for members of the FGG and find that both figures are well in excess of any amount of economic capital necessary to offset operational risk. As shall be discussed in more detail below, most operational risk is offset through economic capital, reserves and risk mitigation, rendering a specific capital charge of the magnitude proposed a massive distortion of the economics of operational risk.

C. The Disconnect Between Economic and Regulatory Capital Will Lead to Arbitrage

Because the proposed ORBC charges are so much greater than the amount of economic capital required, this proposal will result in risk arbitrage, with the same destructive effect the Committee is seeking to eliminate in the proposed credit RBC rules. This will, as discussed below, lead banks to shed existing insurance or other risk mitigants, since the Committee proposes to provide no capital credit for them. It could also induce some firms to drop their banking charter, moving asset management, payments processing and comparable activities into non-banking affiliates. There is considerable non-banking competition in lines of business captured by the ORBC proposal, and

some banks may become non-banks to remain competitive. This would have the effect of increasing systemic risk, as well as posing potential problems for investors.

These effects are directly contrary to the Committee's announced goal of increasing regulatory reliance on market discipline. A regulatory capital charge that creates an incentive for banks to drop risk mitigation will reduce, not enhance, market discipline because banks will not use market options to manage risk, but instead rely on an arbitrary regulatory capital charge to absorb it. Further, to the degree that banks "de-bank," moral hazard may increase because regulators could find themselves forced to rescue a non-banking firm, directly or indirectly, as the Federal Reserve had to do for Long-Term Capital Management in 1998. Moral hazard is already a serious problem in the global financial system without implementation of a capital rule that could increase it by moving major lines of business outside the explicit safety net where regulation acts to reduce moral hazard.

1. Disincentive for Risk Mitigation

The proposal does not provide ORBC credit for operational risk mitigation, including strong risk management and controls, insurance or guarantees. Further, as is made clear in QIS 2, no credit will be provided for risk out-sourced to third parties. The proposal does not address other forms of risk mitigation — e.g., backup power generators, state-of-the-art security, etc., but it appears clear that banks would also enjoy no capital benefit if they incur the cost of upgrading their systems and procedures to minimize operational risk. In essence, the banks that are the best operational risk managers will bear the highest effective capital charge. This is analogous to the problem today with the credit RBC rules, which impose the highest effective RBC on banks with the lowest-risk portfolios.

The Committee explains the decision to exclude risk mitigation by stating that providing capital credit for risk mitigation would introduce new risks, i.e., liquidity and counterparty risk. However, these risks can clearly be addressed through the supervisory Pillar 2. If banks are in compliance with the Committee's liquidity risk management standards and home-country rules implementing them, then the liquidity risk associated with operational risk mitigation should be minimal.

Counterparty risk can be easily addressed through supervisory standards and best practices with regard to acceptable providers of operational risk mitigation. We would note that the U.S. regulators have in place a variety of supervisory measures addressing the risks related to outsourcing which could easily be adopted for international use. Further, insurance companies are highly regulated by standards that include capital adequacy requirements.

The pending changes to the credit RBC rules recognize credit risk mitigation because the Committee has rightly realized that the current rule's failure to do so has created a perverse incentive for banks not to mitigate their credit risk. The result will be the same if an uneconomic ORBC requirement is implemented that fails to provide credit for risk mitigation. Banks will have incentives to shed insurance policies, reduce or eliminate third-party guarantees and cancel outsourcing arrangements originally intended to provide risk mitigation. This is clearly an unacceptable policy result, but it is an inevitable one if the proposed ORBC rules are implemented.

The proposal could also increase systemic risk if banks act on the incentives in the regulation to reduce or drop risk mitigation measures. If subjected to an uneconomic RBC charge, they will likely view the new capital as a form of self-insurance. However, operational risk is generally fat-tailed. That is, any risk that cannot be borne by operating income is a very severe and highly unusual event, such as a once-in-a-century flood, a terrorist attack, etc. Self-insurance through a capital charge will be insufficient to address these risks, which third-party insurance is structured and priced to absorb. A bank without sufficient third-party risk mitigation could experience severe losses as a result of an unexpected and unexpectable operational loss, and these losses could quickly translate through the financial system to other institutions (which may also lack risk mitigation as a result of the ORBC rule).

2. Charter Conversion Potential

As noted, members of the Financial Guardian Group include U.S. banks who are leading asset managers. As the Committee is aware, this line of business can be — and often is — conducted in non-banking institutions in the United States. Such firms are among our major competitors, and these companies, like most non-bank asset managers, have not opted to become financial holding companies. They already find the holding-company capital imposed on FHCs too burdensome, and they would surely continue to avoid coming under bank capital standards if the ORBC charge is instituted.

As a result, bank-owned and FHC-owned asset managers will bear a significant capital burden in contrast to non-bank firms. Using the proposed range of capital charges in Annex 3 of the January consultative paper, bank asset managers could bear a charge of at least a few tenths of a percent on assets under management. In a business in which fees can be *less* than this amount, a capital charge could wipe out profitability. Under even a “modest” charge, bank asset managers would be severely affected.

Some might choose to shed their bank charters to avoid a punitive and uneconomic capital charge. As noted, this could significantly increase systemic risk, since holders of trillions of dollars of customer assets would be outside the reach of bank regulation. In the event of market volatility, some asset managers might lack the liquidity to honor customer instructions, especially if funds have been commingled with other assets. Regulators might then feel compelled to rescue such non-bank asset managers to protect markets and investors in them, increasing moral hazard and distorting the financial system for the remaining regulated institutions.

Further, creating a regulatory incentive for asset management to move outside the banking system could create risk to investors. Non-bank asset managers are not subject to the extensive supervision now applicable to banks. Their fiduciary obligations to customers also vary under law. As a result, it is possible that asset management conducted outside of banks could raise the risk to investors that assets will be invested in inappropriate ways or that funds could be misallocated. Several G-10 countries, most notably the United Kingdom, have had recent and disastrous experience with unregulated investment managers. It is imprudent for the Committee to implement a proposal that will create a strong incentive for asset management activities to migrate outside the banking system.

The same charter arbitrage could occur in other lines of business affected by the ORBC proposal. For example, payments processing can be executed in the U.S. through bank or non-bank enterprises. Some of the largest payments service providers — First Data Corp., for example — are not banks or financial holding companies. Thus, they operate outside the framework of regulation governing bank payments service providers. With a new and onerous capital charge, some bank payments providers will likely "de-bank" to remain competitive. This will also increase systemic risk and create the potential that regulators will need to intervene to support a non-bank provider, also increasing moral hazard instead of promoting market discipline.

D. The Proposal Will Result in Serious International Inequities

One of the avowed goals of the Committee is to create a capital framework that is equitable across all of the nations that implement the Basel 2 accord. However, this will not be the effect if the ORBC charge is adopted. Instead, we fear that U.S. banks would operate at a serious competitive disadvantage.

There are very wide variations in the nature of bank regulation and in the legal system in which banks operate. In the U.S., financial institutions operate at risk of significant civil money penalties and also of the costs associated with class-action litigation. This is simply not the case in most other countries. Often, regulatory problems are addressed through non-financial methods, such as a negotiated agreement to remedy a violation. None of these cases would be captured in the ORBC charge because they would have no financial impact on a bank.

Further, banks in the U.S. operate in a legal framework that exposes them to penalties for actions that are not illegal or even considered improper in other nations. For example, U.S. banks are subject to potential penalties for violations of laws and rules against employment discrimination or failing to provide access to the disabled. The QIS 2 makes it clear that the costs associated with such compliance are to be captured in the ORBC scheme. Again, U.S. banks would have to hold capital not required in other jurisdictions where there are no laws against lending discrimination and similar social concerns.

One might counter that it is not inequitable to impose a higher ORBC charge on U.S. institutions because they operate in a higher-risk legal framework. However, these risks are already captured by U.S. regulators in their "supervision by risk" framework, which requires specific supervisory scrutiny of "legal," "compliance," and "reputational" risks. Pillar 2 incorporates many aspects of the U.S. "supervision-by-risk" framework, and the Financial Guardian Group urges the Committee to adopt this approach also for operational risk.

Further, we would note that the proposal does not take explicit account of the higher operational risks in other countries, such as the costs associated with uncertain power or telephone service. Unless or until supervisors in countries with uncertain infrastructures implement a "supervision by risk" framework, these risks will not be addressed in any fashion, while U.S. banks will bear not only the costs associated with their supervisory regime, but also a new capital charge.

E. A Tax on Investors

Finally, the Financial Guardian Group believes that the ORBC proposal has another major public policy flaw: it will act as a tax on investors. The proposed charges for asset management and custody services will, as noted above, be very costly. Those banks that decide to continue to offer these services in a structure that comes under the Basel accord will therefore seek to the greatest degree possible to pass as much of this charge along to customers. Given the magnitude of the potential ORBC capital charge, this cost to investors could be significant, reducing the amount of savings individual investors will have for retirement and institutional investors will have to meet their pension obligations or other commitments. The rule will also have an adverse impact on capital formation because of its cost to investors. Funds will disintermediate from the capital markets into regulatory capital, reducing those available to support economic growth.

A simple example demonstrates clearly how costly this proposal could be to individual investors. With regard to asset management, we infer a potential ORBC capital charge by reference to page 22 of Annex 3 in the section of the consultative paper describing the ORBC proposal. That page proposes a beta factor (capital charge) of at least a few tenths of a percent, and goes as high as single digit percentages. We take a mid-point estimate of 50 basis points as the capital charge and then further assume that a bank absorbs half of this charge and passes the other half — 25 basis points — on to an individual investor.

Asset management services are generally charged on a fee basis, so a 25 basis point increase in the fee would result in a 25 basis point reduction in the effective return on investment. Assume an individual has a $100,000 retirement nest-egg on which interest compounds monthly at a 6% rate. At the close of thirty years, this investor would have $602,258. However, after the fee resulting from the ORBC capital charge is imposed, the thirty-year $100,000 investment results only in $558,945, a $43,313 difference. This 7% difference in the amount of return an investor receives resulting from the ORBC capital charge will significantly reduce the funds available to individual investors saving over time, as well as profoundly and adversely affect the return institutional investors can expect.

III. Technical Issues

Individual members of the Financial Guardian Group will be providing detailed technical comments on the proposal, as well as answers to QIS 1 and QIS 2 as appropriate. We also are prepared to provide such comments on behalf of the Group as a whole, and would be pleased to respond to any inquiry from the Committee. However, our fundamental position is that imposition of an operational risk-based capital charge is wrong and that no technical revisions to an ORBC charge can make the concept itself right.

The fact that technical fixes to the rule are insufficient is clear from the QIS 2, which attempts to establish a framework for the “internal measurement approach” or IMA for ORBC. The sheer complexity of the QIS 2 document, especially its various flow-charts, leads us to believe that the idea is unworkable. We also believe that the many ambiguities in the QIS 2 survey will provide the Committee with incomplete and misleading data for many of the items covered. For example, Annex 3 in QIS 2 assumes correlations between activity levels and losses, but no correlations are

demonstrated. Often, activity levels reduce losses on a percentage basis because major players in a particular activity invest in risk mitigation and have sophisticated internal risk control operations. While a large custodian or asset manager might have on a dollar-volume basis operational losses larger than a small one, the percentage of loss may well be far smaller. Thus, a uniform capital charge would be highly inappropriate.

We are not aware of any data the Committee now has on hand to validate its approach to ORBC. An effort by the Committee to survey banks earlier on economic capital resulted in incomplete and non-comparable data, and the survey did not in fact seek data on economic capital with specific regard to operational risk.

We urge the Committee not to seek data to validate a theory constructed based on an erroneous understanding of operational risk and then to use the data to construct an ORBC charge.

IV. Conclusion

As noted, the Financial Guardian Group strongly opposes an ORBC capital charge and believes that the Committee should instead pursue a supervisory approach. We shall shortly provide the Committee with more details about our Group and a specific proposed approach to Pillar 2 control of operational risk. In the interim, we would be pleased to answer any questions the Committee may have.

Sincerely,

Karen Shaw Petrou
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