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OPERATIONAL RISK IN BASEL II

MICHAEL E. BLEIER[1]

The Basel Capital Accord[2] (Accord or Basel I) is a fairly complex quantitative driven method for determining regulatory capital. The current state of the Accord has followed a long and tortuous path since January 16, 2001, when the Basel Committee on Banking Supervision released its second consultative document on the New Basel Capital Accord (New Accord or Basel II).[3] This followed the initial indication in June 1999 that a new risk-sensitive capital accord was necessary, supplanting Basel I which has been in place since 1988. The January 2001 Basel proposal was originally intended to be finalized by year-end 2001 with an effective date of 2004. Those final dates have been extended to mid-2004 with implementation hoped for by the end of 2006.[4] A third consultative document was issued in April 2003,[5] and the U.S. bank regulators

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2. *See generally* BASEL COMMITTEE ON BANKING SUPERVISION, BANK FOR INTERNATIONAL SETTLEMENTS, INTERNATIONAL CONVERGENCE OF CAPITAL MEASUREMENT AND CAPITAL STANDARDS (1988), http://www.bis.org/publ/bcbs04A.pdf [hereinafter BASEL I].

3. BASEL COMMITTEE ON BANKING SUPERVISION, BANK FOR INTERNATIONAL SETTLEMENTS, CONSULTATIVE DOCUMENT: THE NEW BASEL CAPITAL ACCORD (2001), http://www.bis.org/publ/bcbsca03.pdf [hereinafter SECOND CONSULTATIVE DOCUMENT].

4. BANK FOR INTERNATIONAL SETTLEMENTS, BASEL COMMITTEE, THE NEW BASEL CAPITAL ACCORD (Jan. 15, 2004), http://www.bis.org/publ/bcbsca.htm.

5. BASEL COMMITTEE ON BANKING SUPERVISION, BANK FOR INTERNATIONAL SETTLEMENTS, CONSULTATIVE DOCUMENT: THE NEW BASEL CAPITAL ACCORD (2003), http://www.bis.org/bcbs/cp3full.pdf [hereinafter THIRD CONSULTATIVE DOCUMENT].

have issued their Advance Notice of Proposed Rulemaking (ANPR), for which the comment period expired on November 3, 2003.[6]

After setting out the general framework of Basel II, this Article will focus on the new additional capital charge for operational risk, currently not part of the Basel I framework. Parts II and III will discuss the proposed Basel II approaches to measuring operational risk and concerns the proposals raise for U.S. banks. Part IV concludes.

I. BASEL II GENERAL FRAMEWORK

In contrast to the 1988 Accord which applied to all banks in the U.S., it was decided that a more risk-sensitive capital approach to regulatory capital was necessary. Instead of the flat basket eight percent capital charge under Basel I, the New Accord has three components:

- Pillar One is a minimum regulatory capital charge for credit risk and for the first time a separate capital charge for operational risk. There is also included a new internal risk-based (IRB) approach. Under Basel II, as a general matter, the capital charge for the credit exposure for an institution meeting the advanced-IRB treatment requirements should decrease considerably below the eight percent level under Basel I. Thus, institutions qualifying for advanced credit treatment will be competitively advantaged (through a lower risk-based capital charge) than those institutions operating under Basel I.[7]

- Pillar Two focuses on supervisory review which basically is intended to allow examiners to focus on overall risk management techniques and internal controls.[8]

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6. Advanced Notice of Proposed Rulemaking, 68 Fed. Reg. 45900-01 (Aug. 4, 2003), *available at* http://www.federalreserve.gov/BoardDocs/Press/bcreg/2003/20030804/attachment.pdf.

7. *See generally* THIRD CONSULTATIVE DOCUMENT, *supra* note 5, at 6-137.

8. *See generally* THIRD CONSULTATIVE DOCUMENT, *supra* note 5, at 138-153.

- Pillar Three recognizes that market discipline has the potential to reinforce capital regulation and other supervisory efforts to ensure the safety and soundness of the banking system. Thus, Pillar Three involves a wide range of disclosure initiatives, which are designed to make the risk in the capital positions of a bank or its parent holding company more transparent.[9]

II. OPERATIONAL RISK

Operational risk is not now captured in U.S. or international capital standards although some banks impose the charge for that kind of risk in their internal economic risk models. Under Basel II, operational risk is defined broadly as "the risk of [direct or indirect] loss resulting from inadequate or failed internal processes, people and systems or from external events."[10]

The regulators recognized in Basel I that institutions were exposed to non-credit-related risks, which included operational risk. Thus, they built a "buffer" into the general risk-based capital rules to cover those other risks that one might argue is found in the broad-based 5% well-capitalized leverage requirement.[11] Logically this "buffer" should disappear with the creation of a specific capital charge for operational risk, but it is being retained by U.S. banking regulators.[12] The same organizations also remain subject to the prompt corrective action legislation and implementing regulations.[13]

The new capital requirement for operational risk can be fairly expensive for specialized financial institutions with significant concentration in asset management, custody, and other businesses that would, for the first time carry a capital requirement. Such a capital charge would disadvantage the more successful specialized

9. *See generally id.* at 154-168.

10. *Id.* at 120.

11. Advanced Notice of Proposed Rulemaking, 68 Fed. Reg. at 45902.

12. *Id.* Well-capitalized: 10% total Risk-Based Capital ratio, 6% Tier One ratio and 5% leverage ratio. *Id.* at n. 4.

13. *Id.*; *see also* 12 U.S.C. § 1831o (2000).

institutions because of their greater gross income, which is probably due to good controls, systems and marketplace recognition.

A. Basel's Three Approaches for Measuring Operational Risk

There are three approaches to calculating operational risk under Basel II, but only one approach under what the U.S. regulators will apply according to the ANPR. The three approaches can be used by non-U.S. organizations subject to these rules, but in the U.S. only the third approach can be used and only by "core banks" and those who choose to opt-in.[14]

- *Basic Indicator Approach*: An example of this approach uses gross income as a proxy for the organization's operational risk exposure. This is calculated by multiplying a particular bank's average annual gross income over the previous three years by 15%.[15]

- *Standardized Approach*: This approach divides an organization's activities into standardized business units (i.e., investment banking, banking and others) and various lines of business: (i) corporate finance, (ii) trading and sales, (iii) retail banking, (iv) commercial banking, (v) payment and settlement, (vi) retail brokerage, (vii) agency services, and (viii) asset management. Risk indicators (from 12% to 18%) are established for each line of business to serve as the proxy for operational risk. The required capital under this approach is determined by multiplying the gross income (or for asset management, total funds under management) by a factor determined by industry loss experience for the given line of business. The total operational risk capital charge for the

14. *See* THIRD CONSULTATIVE DOCUMENT, *supra* note 5, at 120; Advanced Notice of Proposed Rulemaking, 68 Fed. Reg. at 45902.

15. THIRD CONSULTATIVE DOCUMENT, *supra* note 5, at 121. The fixed percentage was 30% under the first Basel II proposal. BASEL COMMITTEE ON BANKING SUPERVISION, BANK FOR INTERNATIONAL SETTLEMENTS, CONSULTATIVE DOCUMENT: OPERATIONAL RISK (2001), http://www.bis.org/publ/bcbsca07.pdf.

organization is the sum of all capital charges for each of the lines of business.[16]

- *Advanced Measurement Approach (AMA)*: This approach allows banks more input into determining their operational risk capital charge, as their capital charge will be based on internally developed models.[17] This is the only operational risk approach proposed by U.S. regulators in the ANPR, which *must* be accompanied on the credit side by using the Advanced-IRB treatment.[18] Both measurements require examiner overview and sign-off.[19]

The AMA is designed to allow each financial institution to use its own methodology for assessing its exposure to operational risk, provided it is comprehensive and results in a capital charge that is reflective of the operational risk experience of the organization.[20] This means one estimates the potential operational losses that the banking institution faces at a soundness standard of 99.9% confidence level over a one-year period (a once in a millennium event).[21] The operational risk exposure would be multiplied by 12.5 to determine a risk-weighted assets equivalent, which is added to the amounts for credit and market risk for the denominator of the regulatory capital ratio.[22] Institutions eligible to use the AMA approach are the "core banks": banks that have total banking and thrift assets of $250 billion or more or have a total on-balance-sheet foreign exposure of $10 billion or more.[23] The second group are those who choose voluntarily to subject themselves to these charges as "opt-in banks."[24] The third group is all the other banks and thrifts

16. THIRD CONSULTATIVE DOCUMENT, *supra* note 5, at 122-23.
17. *Id.* at 123-30.
18. Advanced Notice of Proposed Rulemaking, 68 Fed. Reg. at 45902.
19. *See* 68 Fed. Reg. at 45902.
20. *Id.* at 45904; *see also* THIRD CONSULTATIVE DOCUMENT, *supra* note 5, at 125-130.
21. 68 Fed. Reg. at 45902.
22. *Id.* 12.5 is the reciprocal of the 8% minimum risk-based capital charge. *Id.*
23. *Id.* at 45906.
24. *Id.*

who would remain subject to Basel I and not incur a separate operational risk capital charge.[25]

Once a bank becomes a core bank it remains subject to the advanced approaches going forward.[26] If it drops below the thresholds it still remains a core bank unless it can show it has permanently downsized.[27] The U.S. regulatory agencies propose an annual test.[28] If the bank approaches the thresholds the agencies will have a dialogue with the bank "to ensure that appropriate practices are in place or are actively being developed to prepare the organization for implementation of the advanced approaches."[29]

B. *FRB Policy Statement*

In 1999, the Federal Reserve adopted Supervisory Policy Statement 99-18 in which examiners were directed to ensure that each institution has a rigorous and comprehensive internal process for evaluating its own capital adequacy to meet formal regulatory standards but also sufficient to support their underlying risk positions.[30] The ANPR and Basel II expand on 99-18 to require specific action steps, which also include greater board and senior management oversight, to use the AMA and an independent operational risk management function, which must submit quarterly reports to the board of directors.[31]

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25. *Id.* at 45907.
26. 68 Fed. Reg. at 45906.
27. *Id.*
28. *Id.*
29. *Id.*
30. Letter Assessing Capital Adequacy in Relation to Risk at Large Banking Organizations and Others with Complex Risk Profiles (SR 99-18) from the Board of Governors of the Federal Reserve System to the Officer in Charge of Supervision and Appropriate Supervisory and Examination Staff at Each Federal Reserve Bank and Certain Domestic Banking Organizations Supervised by the Federal Reserve (July 1, 1999), 1999 WL 461146 (F.R.B.) [hereinafter Supervisory Policy Statement 99-18].
31. *Id.*

III. WHAT ARE SOME OF THE CONCERNS ABOUT OPERATIONAL RISK?

A. *Definitional Problem*

Since proposing operational risk, there have been ongoing difficulties in defining operational risk. This definitional problem has been recognized and acknowledged by the Basel Committee in its public comments as well as by Jerry Hawke, the Comptroller of the Currency, and the Federal Reserve Banks of Chicago, Richmond and San Francisco.[32] All question whether operational risk can be accurately defined or effectively offset by a regulatory capital charge. Jerry Hawke, for example, said, "[a] one-size-fits-all approach to operational risk . . . while simple to apply, would disadvantage the best managed banks and provide undeserved advantage to the worst managed. Worst of all, it would provide no incentive to improve internal control systems."[33] Of course, having excessive capital can impair financial performance and impact competitiveness.

The ANPR and Basel II attempt to treat operational risk under a model more suited to credit risk. The proposal, by focusing primarily on regulatory capital,[34] shifts attention and resources away from critical risk management efforts, and creates perverse incentives to avoid investment in important operational risk infrastructure, processes, and people. As must be recognized, a 9/11-type risk (such as bio-terror or a nuclear blast) makes capital irrelevant. Contingency planning, disaster preparedness, back-up facilities and

32. *See, e.g.,* Letter from the Federal Reserve Bank of Chicago to the Basel Committee on Banking Supervision, Bank for International Settlements at 10 (May 31, 2001), http://www.bis.org/bcbs/ca/ferebkofch.pdf; Letter from the Federal Reserve Bank of Richmond to the Basel Committee Secretariat, Bank for International Settlements at 2-3 (May 30, 2001), http://www.bis.org/bcbs/ca/ferebkofri.pdf; FRBSF Economic Letter, Federal Reserve Board of San Francisco at 4 (Jan. 25, 2002), http://www.frbsf.org/publications/economics/letter/2002/el2002-02.pdf.

33. John D. Hawke, Jr., Comptroller of the Currency, Remarks before the Institute of International Bankers 9 (Mar. 4, 2002), *available at* http://www.occ.treas.gov/ftp/release/2002-17a.doc.

34. As opposed to economic capital, which "is often used to refer to the amount of capital that should be allocated to an activity according to the results of such an exercise." 68 Fed. Reg. at 45902.

redundancies limited losses from 9/11.[35] The AMA approach does not fully recognize and account for these risk mitigation efforts in part because there is no accepted method to define or measure operational risk.

On October 11, 2003 the Basel Committee on Banking Supervision announced that it will separate out the treatment of expected loss and unexpected loss, with the resulting IRB proposal being a measurement of risk-weighted assets based solely on the unexpected loss portion of the IRB calculation.[36] This means significant reliance on external loss data experiences. Tied in with this approach is the requirement that if there is a shortfall in coverage where the expected or actual loss exceeds the provision, there is a deduction of the shortfall in equal amounts from Tier One and Tier Two capital.[37] If there is an excess, the overage is added to Tier Two, but this amount cannot exceed 20% of Tier Two capital.[38]

Operational risk can include costs necessary to fix systems problems, payments to third parties, write-downs, decisions to absorb losses to maintain ongoing client relationships, near misses, late losses or contingent losses. Theoretically, operational risk should only be for unexpected losses, since provisions are covering expected losses. However, it is often difficult for banks to hold reserves against unexpected operational losses; moreover, in some countries, including the U.S., accounting rules make it very difficult for banks to hold reserves related to operational events that have yet to occur. The banking community must wait to see how the SEC, which has long pushed for lower loan loss reserves, will treat the new operational risk capital rules. In any event, the SEC is not likely to raise an accounting challenge to explicit capital standards imposed by regulation.[39]

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35. Letter from Karen Petrou, Executive Director, Financial Guardian Group, to the Federal Reserve Board, Federal Deposit Insurance Corporation, Comptroller of the Currency and the Office of Thrift Supervision (Nov. 3, 2003) [hereinafter Karen Petrou Letter], *available at* http://www.fdic.gov/regulations/laws/federal/03CFGG.html.

36. Press Release, Basel Committee on Banking Supervision, Basel II: Significant Progress on Major Issues (Oct. 11, 2003), http://www.bis.org/press/p031011.htm. The comment period closed on December 31, 2003. *Id.*

37. *Id.*

38. *Id.*

39. Karen Petrou Letter, *supra* note 35.

Many types of what might be called unanticipated operational losses, such as credit card fraud, are accounted for through end of quarter adjustments to loss provisions instead of through an ongoing capital charge. In that case, the bank would have to disclose its methodology and its adjustments would have to reflect the unexpected as well as experienced losses. These operational losses are really viewed as a cost of doing business, included on the profit and loss statement and covered by the ongoing and consistent fee revenue stream and recurring earnings of an institution. Thus, operational risk is really an earnings at risk issue, not a capital at risk issue.

B. *Collection of Loss Data*

Another major problem is the Basel II-required internal assembly or accumulation of up to five years of internal operational risk loss data across all material business lines, events, product types and geographic locations.[40] The types of loss event data that should be collected include:

- Internal and external fraud;
- Employment practices and workplace safety;
- Client, products and business practices (includes fiduciary);
- Damage to physical assets;
- Business disruption and system failures; and
- Execution, delivery, and process management i.e., failed transaction processing.[41]

The accumulation of this data for regulatory purposes may subject banks to greater exposure in litigation as such data could create

40. THIRD CONSULTATIVE DOCUMENT, *supra* note 5, at 127.
41. *Id.* at 202 (Annex 7).

a road map for the plaintiff's bar. Because of the chilling effect of such potential exposure, candid internal risk assessment may be jeopardized. In addition, there will be reluctance to share loss data on an industry-wide basis particularly where there is no assurance that such sensitive data can be protected. Also, competitive risk exists in such external databases. Nevertheless, without an appropriate industry loss database, it is hard to visualize how the regulators can go forward on the loss data issue. It should be noted that a lot of the loss data may be irrelevant if banks can absorb the loss as part of their cost of doing business.

C. *Inconsistent National Supervisory Treatment*

There is a valid concern that the operational risk components may be applied inconsistently across national jurisdictions. As has often been noted by Jerry Hawke, U.S. banks operate in a far different, in many ways stricter, regulatory environment than non-U.S. competitors.[42] For example, the common use by U.S. regulators of on-site examination teams is simply not the practice in most other jurisdictions. In addition, the U.S. proposal to retain both the leverage ratio and prompt corrective action regime for U.S. banks operating under the New Accord creates additional capital demands on U.S. banks. As a result, any additional capital requirement for U.S. banks, including the operational risk requirement, will have a greater impact on U.S. banks than banks operating in other national jurisdictions.

D. *Undue Reliance on External Data*

"Under the ANPR, the AMA continues to rely too heavily on . . . external data. External data provides valuable information for

42. *The New Basel Accord – In Search of a Unified U.S. Position: Hearing Before the House Subcomm. on Fin. Institutions and Consumer Credit of the Comm. On Fin. Services*, 108th Cong. 11-12 (June 19, 2003) (testimony of John D. Hawke, Jr., Comptroller of the Currency, Office of the Comptroller of the Currency), http://financialservices.house.gov/media/pdf/061903jh.pdf; *The New Basel Accord – Sound Regulation or Crushing Complexity?: Hearing Before the House Subcomm. On Domestic and Int'l Monetary Policy, Trade and Tech. of the Comm. On Fin. Services*, 108th Cong. 13-14 (Feb. 27, 2003) (testimony of John D. Hawke, Jr., Comptroller of the Currency, Office of the Comptroller of the Currency), http://financialservices.house.gov/media/pdf/022703jh.pdf.

qualitative reviews of an institution's risk management systems and internal controls. It is not, however, suitable as a basis for a quantitative capital calculation."[43]

For example,

> scaling external data to make it relevant to a bank's risk profile, system of internal controls, and other risk management factors is a difficult and uncertain process. Moreover, the integrity, completeness, and general data quality of external databases are often questionable and difficult to ascertain and control. Much publicly available operational loss data is based on relatively extreme risk management failures. Mandating the use of such data risks imposing capital requirements based on the "lowest common denominator" of risk management practices—an approach that would penalize banks with well-developed control systems, and low losses. Sharing such data between institutions, or other third parties, as noted above, will also raise serious privacy, confidentiality, legal, and competitive issues.[44]

E. Indirect Loss Data

The bank regulatory agencies "specifically solicited comment regarding the possible inclusion of the risk of indirect losses, such as opportunity cost, in the definition of operational risk .... First, quantifying the risk of such losses, and converting that risk to a capital requirement, will be next to impossible. Second, such indirect losses are far more related to a bank's business plan than its risk management function, and should continue to be appropriately accounted for in a bank's income statement, not its regulatory capital requirements."[45]

43. Letter from David Spina, Chairman and Chief Executive Officer, State Street Corporation, to the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Coporation, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision (Nov. 3, 2003) [hereinafer Spina Letter], *available at* http://www.fdic.gov/regulations/laws/Federal/03cstatest.html.

44. *Id.*

45. *Id.*

Moreover, strategic risk is excluded from operational risk.[46] What about a business decision to forego a particular line of business because of an ultimately unwise management decision? How do you determine the revenue that was forgone and the capital charge against it? What about an alternative strategy? Does that trigger a capital charge? The profit and loss statement appropriately encompasses these kinds of business decisions and judgments. This really lies within the "business judgment" rule, not a capital rule.[47]

F. Treatment of Legal Risk

"While legal risk is certainly a factor in an institution's risk profile, such risks are among the most difficult to quantify for purposes of a Pillar One capital requirement."[48] This type of risk includes the risk resulting from tort liability, securities suitability standards, and the laws against loan and employment discrimination – among many others. These same legal standards, of course, do not apply in many other nations."[49]

Why would U.S. regulators "agree to a capital charge for U.S. banking institutions arising from laws and regulations unique to the U.S. that are designed to achieve our own social objectives–especially given the unique U.S. requirement for reserves against material legal risk. In addition, these are laws which have no known bearing on any bank's failure."[50] Further, reputation risk is specifically excluded from the definition.[51]

In cases where a bank may be subject to legal risk, securities law requires full disclosure of material matters, thus the operational risk proposal would have no new impact on market discipline. Moreover, litigation loss history provides limited insights into future losses, creating significant challenges to modeling. Since legal losses

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46. THIRD CONSULTATIVE DOCUMENT, *supra* note 5, at 120.
47. Karen Petrou Letter, *supra* note 35.
48. Spina Letter, *supra* note 43.
49. *A Review of the New Basel Capital Accord: Hearing Before the S. Comm. on Banking, Housing and Urban Affairs*, 108th Cong. (June 18, 2003) (testimony of Karen Petrou, Managing Partner, Financial Analytics, Inc.), http://www.fedfin.com/press_center/Petrous_senate_testimony_061803.pdf.
50. *Id.*
51. *Id.*

are typically closely linked to individual events and circumstances, the use of external data is particularly inappropriate for legal risk. Finally, the U.S. legal system poses the highest litigation risk of any G-10 country. A stark example is that two large U.S. banks have been sued for their asserted participation in the slave trade — over 200 years ago. As a result, U.S. banks will likely be required to set aside more capital for litigation risk than their foreign competitors. This could result in a significant competitive disadvantage for U.S. banks.[52]

G. *Insurance*

Legal risk is unique in that the initial estimated exposure is often not resolved for many years. Yet, insurance is a widely accepted and fairly successful mitigant for this type of risk. Nevertheless, under Basel II and the ANPR insurance must be capital-like to provide the necessary cushion.[53] The insurance must have the following characteristics: (i) be provided by a nonaffiliate with a minimum claims paying ability rating of A; (ii) have an initial term of no less than one year; (iii) not contain an exclusion for regulatory actions; (iv) have clear cancellation and nonrenewal notice periods; and (v) have coverage that has been explicitly mapped to actual operational risk exposure.[54] Also, the bank regulatory agencies should eliminate the proposed 20 percent limit on reductions in the AMA capital calculation for insurance as a mitigant. This 20% cap does not appear to have any analytical or statistical basis. In fact, insurance can provide far more leverage than capital in addressing the low frequency, high severity loss events which may exceed an institution's ability to cover with earnings. Imposing a specific regulatory cap of 20%, or any other percentage, will create a disincentive for banks to hold insurance, will stifle innovation in new insurance-related (and other) risk management products, and will greatly reduce the risk sensitivity of the proposed New Accord.

52. Karen Petrou Letter, *supra* note 35.

53. THIRD CONSULTATIVE DOCUMENT, *supra* note 5, at 129-30; Advanced Notice of Proposed Rulemaking, 68 Fed. Reg. at 45943.

54. THIRD CONSULTATIVE DOCUMENT, *supra* note 5, at 129-30.

H. *Alternative Approach for Primarily Fee-Based Services*

While the credit risk benefits of the New Accord may offset the negative impact of the new operational risk requirement for banks engaged in traditional lending activities, the opposite is true for banks primarily providing fee-based services, such as investment servicing and asset management. For banks engaged primarily in fee-based service businesses, the New Accord and the ANPR impose an additional capital requirement, largely through the operational risk requirement, while leaving their competitors, (i.e., investment management firms, broker-dealers, insurance companies, investment banks, mutual funds, leasing companies and business services and software companies) with no capital requirement for operational risk. The result is a marketplace distortion, creating a regulatory incentive for banking organizations to move activities outside the reach of Basel II.[55]

An alternative that has been proposed to the Pillar One capital requirement is a rigorous Pillar Two supervisory approach.[56] Placing operational risk management under Pillar Two would allow the agencies to impose strict operational risk regulatory requirements, including requirements related to capital adequacy, without creating the negative competitive and technical impacts of a Pillar One requirement.[57]

Absent the adoption of a Pillar Two approach for operational risk, for predominately fee-based financial organizations with a bank component that subjects them to Basel II, an alternative is to allow them to use the AMA for operational risk and an optional credit

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55. Letter from Members of the House Committee on Financial Services to Alan Greenspan, Chairman, Federal Reserve Board, John D. Hawke, Jr., Comptroller, Office of the Comptroller of the Currency, Donald E. Powell, Chairman, the Federal Deposit Insurance Corporation, James E. Gilleran, Director, Office of Thrift Supervision at 7-8 (Nov. 3, 2003), http://financialservices.house.gov/media/pdf/ANPR%20Comment_001.pdf..

56. *See* Letter from Financial Guardian Group to the Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, and the Office of Thrift Supervision (Nov. 3, 2003), http://www.federalreserve.gov/SECRS/2003/November/20031105/R-1154/R-1154_23_1.pdf

57. *See id.*

approach where credit risk is not the business driver.[58] For example, they could use the AMA for operational risk and Basel I (or Standardized-IRB) for credit exposure. This credit alternative would be a much simpler, less costly approach for these institutions and more consistent and in line with the low credit exposure in their portfolios. Even if there were alternative options, under the ANPR the great majority of U.S. banks will remain under Basel I, unless they choose to opt-in to the New Accord.

I. Corporate Governance and Management Structure

The bank regulatory agencies, "in both the Advanced-IRB and AMA, propose extensive new requirements for banks' corporate structure and management."[59] "The highly prescriptive structure of the agencies' proposal provides little flexibility in establishing an internal risk management structure best suited to a bank's particular needs."[60] The agencies place "inappropriate and unduly burdensome responsibilities on a bank's board of directors" and fail to "clearly delineate the respective responsibilities of the board and senior management."[61] Moreover, based on an analysis of banks regulatory rules and statutes, the board of directors of a bank or parent holding company has been assigned some type of new, Basel II-related responsibility in over 200 instances.

"As proposed by the agencies, the responsibilities imposed on the board of directors are excessively detailed, and go well beyond a board's appropriate supervisory and strategic role."[62] For example, the ANPR requires the board to:

- maintain "effective internal controls over the banking organization's information systems and processes for assessing adequacy of regulatory capital and determining regulatory capital charges,"[63]

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58. As proposed, those using the AMA must also use the Advanced-IRB approach. *See supra* note 18 and accompanying text.
59. Spina Letter, *supra* note 43.
60. *Id.*
61. *Id.*
62. *Id.*
63. *Id.*

- approve all "significant aspects of the rating and estimation processes,"[64] and

- "ensure that appropriate resources have been allocated to support the operational risk framework."[65]

- The ANPR also requires the board or a committee of the board to "oversee the development of the firm-wide operational risk framework."[66]

The board of directors' role in the risk management process should be supervisory, focusing on the oversight of management's activities and broad supervision of the implementation of regulatory requirements. The board should not be charged with the responsibility for the day-to-day risk management function of a bank. The board of any banking organization is unlikely to be comprised of directors with the time or skill set required to carry out the highly technical and extensive requirements proposed by the agencies. The unintended consequence of placing excessively detailed demands on the board will mean less board resources, time, and attention devoted to broader supervisory, strategic, and risk management responsibilities.[67]

In addition to these broader concerns related to the proper role of the board of directors, the proposed rules do not sufficiently delineate the separate responsibilities of the board of directors and senior management. Many of the requirements proposed by the agencies impose duties on the board and management combined, but do not specifically allow for division of responsibility between these two groups. These requirements do not provide sufficient guidance for the board to determine the extent to which it needs to be involved. For example, it is unclear if the mere approval by the board of funding to support an operational risk framework is sufficient to fulfill its responsibilities, or if the board's responsibilities can only be

64. *Id.*
65. Advanced Notice of Proposed Rulemaking, 68 Fed. Reg. at 45942.
66. *Id.*
67. Spina Letter, *supra* note 43.

met through extensive development of detailed plans, policies, and budgets.[68]

[The bank regulatory] agencies should revise the ANPR to more closely align any new board responsibilities with the board's strategic and oversight roles, to avoid placing management functions on the board, to provide for clearer delineation of board and management responsibilities, and, when appropriate, to allow board delegations of its responsibilities to either board committees or senior management.[69]

J. Congressional Reaction

Congress has held a series of hearings on Basel II, most recently on June 18, 2003 (by the Senate Banking Committee)[70] and June 19, 2003 (by the House Financial Institutions and Consumer Credit Subcommittee of the Financial Services Committee).[71] The hearings also encompassed a review of operational risk under Basel II. In a November 3, 2003 letter to the Federal bank regulators on the ANPR, the House Committee on Financial Services' key committee and subcommittee chairmen and ranking minority members stated they had concerns about the major competitive and market structure issues raised by Basel II and the ANPR.[72] Their letter also stated that "Basel II should be reviewed by Congress prior to any final agreement that would affect U.S. and U.S.-based financial institutions in such a significant manner."[73] Such a

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68. *Id.*

69. *Id.*

70. *A Review of the New Basel Capital Accord: Hearing Before the S. Comm. on Banking, Housing and Urban Affairs*, 108th Cong. (June 18, 2003), http://banking.senate.gov/index.cfm?FuseAction=Hearings.Detail&HearingID=42.

71. *The New Basel Accord – In Search of a Unified U.S. Position: Hearing Before the House Subcomm. on Fin. Institutions and Consumer Credit of the Comm. On Fin. Services*, 108th Cong. (June 19, 2003), http://financialservices.house.gov/hearings.asp?formmode=detail&hearing=236.

72. Letter from Members of the House Committee on Financial Services to Alan Greenspan, Chairman, Federal Reserve Board, John D. Hawke, Jr., Comptroller, Office of the Comptroller of the Currency, Donald E. Powell, Chairman, the Federal Deposit Insurance Corporation, James E. Gilleran, Director, Office of Thrift Supervision (Nov. 3, 2003), http://financialservices.house.gov/media/pdf/ANPR%20Comment_001.pdf.

73. *Id.* at 12.

Congressional review would be analogous to the review of a trade agreement or treaties which define the relationships between the U.S. and foreign countries.[74] In this case, Basel II and the ANPR set forth relationships between how U.S. and foreign financial institutions are supervised on a global level.[75]

K. Further Basel II and ANPR Concerns

The ANPR and Basel II still apply a floor even on institutions that meet the difficult standards to qualify for AMA and Advanced–IRB, because they would be required to hold no less than 90% of their current Basel I capital levels in the first year after implementation and no less that 80% in the second year. This creates limited incentive for low-risk institutions to make the significant investments in all of the Basel II models, particularly for those that would see an increase in their capital charge. Also, they must re-qualify and be recertified by the regulators in year three for the advanced treatment under the ANPR if the limits on Basel II recognition are dropped going forward. In addition, much more easily quantified risks such as interest-rate risk, liquidity risk and foreign exchange risk are not included as a new capital charge in the ANPR.

IV. CONCLUSION

As proposed, the New Accord and the ANPR seek a more risk sensitive approach to determining capital charges. Previously unrecognized, the New Accord and ANPR would account for operational risk. Given the high thresholds to be considered a "core bank" subject to mandatory application of the ANPR, most U.S. banks will escape application of the capital rules for operational risk. The concerns addressed in this article might indicate many U.S. banks would decline to opt-in to this regulatory regime, but I assume almost all of the banks over $50 billion in assets will eventually choose to become subject to Basel II.

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74. *See id.*
75. *Id.*