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House of Representatives Passes Bill to Address Calculation of Operational Risk RWAs Under U.S. Basel III

By Luigi L. De Ghenghi, Andrew Rohrkemper & Ryan Johansen on March 12, 2018

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Continuing the trend of Congressional attention to U.S. capital requirements for banking organizations, the United States House of Representatives **has passed** a bill that seeks to address the calculation of risk-weighted assets (**RWAs**) for operational risk under the U.S. Basel III capital rules (**House Bill**). The **House Bill** would prohibit the U.S. banking agencies from establishing an operational risk capital requirement unless that requirement is appropriately risk sensitive and based primarily on the risks posed by a banking organization's current activities and businesses, as determined under a forward-looking assessment of the banking organization's potential losses. The U.S. banking agencies would be prohibited from basing this forward-looking assessment solely on a banking organization's historical losses. Any such requirement must also permit, as is the case under the current U.S. Basel III capital rules, adjustments based on qualifying operational risk mitigants (e.g., insurance).

The House Bill wades into this issue at a time when the U.S. banking agencies must decide whether and how to align the existing U.S. Basel III operational risk capital requirements with recently revised international standards. Currently under the U.S. Basel III capital rules, only advanced approaches banking organizations are subject to operational risk capital requirements. There is no requirement for the calculation of operational risk RWAs under the U.S. Basel III standardized approach.

In December 2017, as part of **finalizing the Basel III capital framework**, the Basel Committee on Banking Supervision (**Basel Committee**) revised the minimum capital requirements for operational risk.[1] The Basel Committee has adopted a single, revised standardized approach for operational risk that replaces the previous three operational risk methodologies – basic indicator approach, standardized approach, and advanced measurement approaches (**AMA**) – under the Basel II

framework. In the United States, because operational risk capital requirements currently apply only to advanced approaches banking organizations, in effect only the AMA applies.

Under the Basel Committee's revised standardized approach, a banking organization's operational risk RWAs would be calculated based on three components:

- the business indicator (**BI**), which is the aggregate of three categories of income averaged over three years,
- the business indicator component (**BIC**), which is the BI multiplied by a percentage based on the amount of BI, and
- the internal loss multiplier (**ILM**), which is a scaling factor based on a comparison of (i) a firm's loss component (15 times a firm's average annual operational losses over a 10-year period) with (ii) the firm's BIC.

A firm's losses are calculated net of recoveries such as payments made by insurance companies. Apart from these offsetting recoveries, there is no specific recognition of risk mitigants, unlike in the current AMA methodology. Subject to supervisory approval, divested activities may be excluded from a firm's calculation of its BI. Operational loss events no longer relevant to a firm's business may also be excluded, subject to supervisory approval, from the firm's loss component. A firm may thus be able to exclude historical losses relating to a divested business from the calculation of its ILM, but only if it is able to show that there is no similar or residual exposure and the excluded losses have no relevance to other continuing activities or products.

Minimum operational risk capital is determined by multiplying the BIC with the ILM. The product is then multiplied by 12.5 (i.e., 1,250%) to calculate the amount of RWAs for operational risk.

Conceptually, the revised standardized approach is predicated on two assumptions—(1) that operational risk in each business area increases at an increasing rate compared to the amount of income derived from that area and (2) that organizations with greater historical operational losses relative to the income derived from their business areas are more likely to experience operational losses in

the future. There are two potential conflicts between the Basel Committee's revised standardized approach and the principles articulated in the House Bill.

First, the House Bill requires operational risk capital requirements to be based on a forward-looking assessment of potential losses, "which is not solely based on a banking organization's historical losses." It is unclear whether the fact that historical losses are one factor, but obviously a determinant factor, in the calculation of a firm's ILM would permit the U.S. banking agencies to implement the Basel Committee's revised standardized approach as currently constructed if the House Bill were enacted. The Basel Committee has agreed that national supervisors should have the discretion to set the ILM scaling factor at 1, which would effectively mean that the minimum operational risk capital would be determined by the BIC. But that simplification would be unlikely to satisfy the House Bill requirement of a forward-looking assessment of potential losses. It could also conflict with the House Bill's requirement that any operational risk capital requirement must be appropriately risk sensitive, as a firm's BIC is based on a standard, one-size-fits-all formula based solely on its BI, without any firm-specific adjustment for potential or historical losses.

Second, the House Bill requires that any operational risk capital requirement must permit adjustments for qualifying risk mitigants. As noted above, there is no specific recognition in the Basel Committee's revised standardized approach for any risk mitigant.

The House Bill faces an uncertain path in the Senate, which is expected to pass a more comprehensive **Bipartisan Banking Bill** that, in its **current form**, does not include a comparable provision on operational risk capital requirements. Even if the House Bill becomes law, it would leave much to the discretion of the U.S. banking agencies. If nothing else, it gives the U.S. banking agencies another set of principles to consider as they determine how to implement the Basel Committee's revised standardized approach in the U.S. Basel III capital rules.

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[1] *See* Basel Committee on Banking Supervision, Basel III: **Finalising post-crisis reforms**, pp. 128-136 (Dec. 2017).