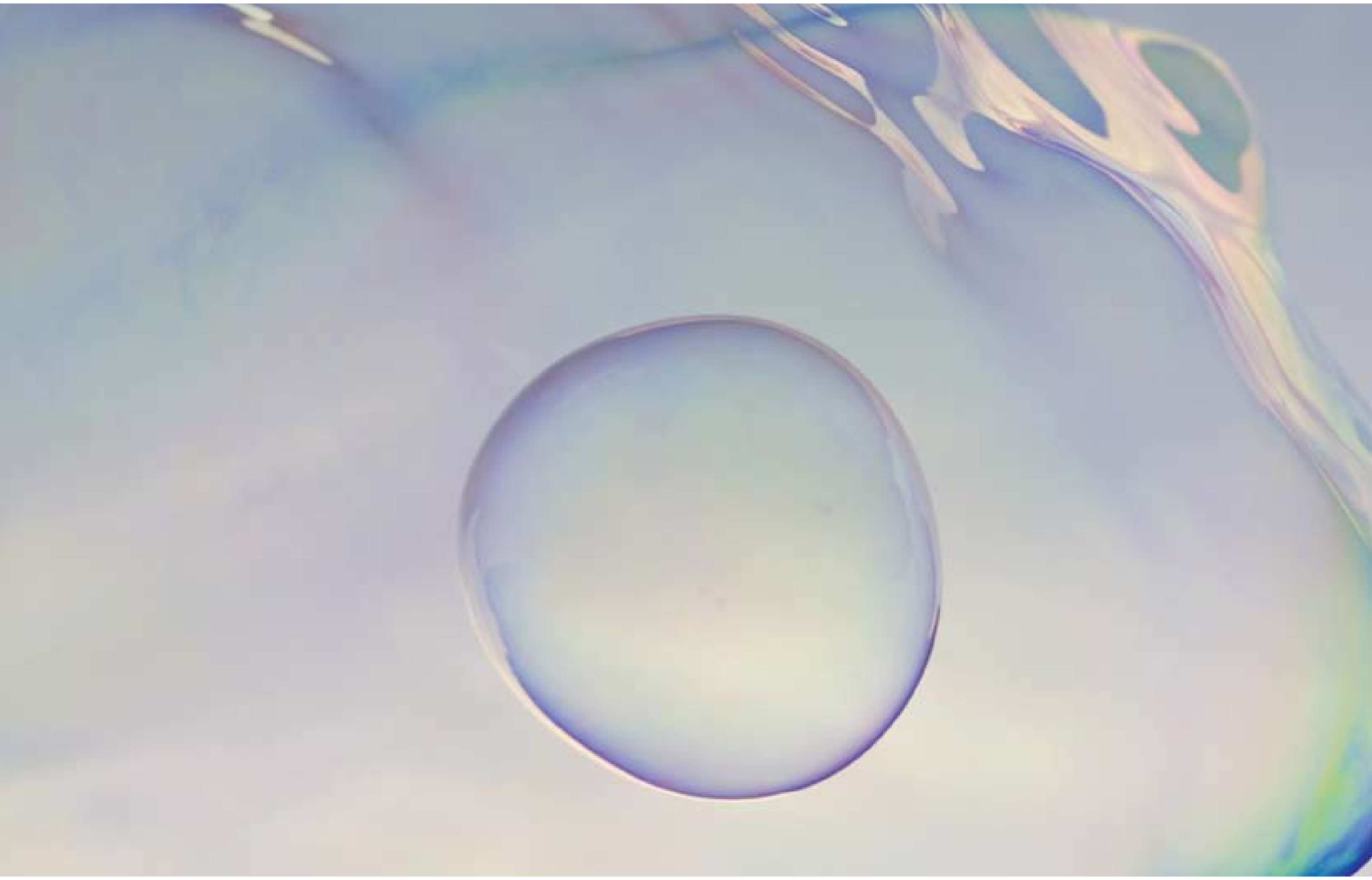
Basel III and operational risk: the missing piece?



Perhaps we should first establish what we mean by operational risk. In financial services, it first came to prominence when Basel II was being negotiated in the late 1990s. Basel II, which became fully operational in 2008, was intended to make banks' capital for credit risk more risk-based, so that lending to a AAA corporation was not treated the same as lending to a small business, as it had been under Basel I.

Operational risk came into the frame for two reasons. First, regulators and banks had noticed that for some years threats to financial services activity had come not from poor credit decisions, but from conduct such as unauthorised trading (Sumitomo and Barings), a reckless lack of controls (LTCM), incompetent strategy (Metallgesellschaft) or technological threats such as the Millennium Bug. Regulators were also worried that the new risk-based approach to credit in Basel II would reduce the sum of global capital in banks and they needed something to put in its place. Hence, capital for operational risk. In the event, global capital for credit under the early proposals didn't reduce globally, but capital for operational risk was here to stay.

Operational risk was defined as 'The risk of loss arising from inadequate or failed internal processes, people or systems, or from external events'. The important point was that it was not just confined to internal operations or processes, but

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included all those problems which arise from employees’ behaviour, as well as exposure to external events, whether environmental, such as 9/11, Hurricane Katrina or Icelandic volcanic ash, or arising from outsourcing and third-party dependencies. Operational risk pervades everything which firms do and, unlike other risk types, is the responsibility of all employees. It therefore lay at the root of the financial crisis.

There was undoubtedly an asset bubble and a credit binge, which was fuelled by the banks and their clients. The banks were cheered on by politicians and left to it by regulators, while everybody, including the central banks, watched the bubble grow. Interestingly, if you look back at the last 200 years, you will find that almost all banking crises have been preceded by an asset bubble, usually a property bubble. Not that all property bubbles lead to a banking crisis, but it’s a useful Key Risk Indicator, to use a good operational risk term, and it was ignored.

Then there were those complex and ‘socially useless’ derivative products. But were they really so complex? Not if you read them properly, which few bothered to do, relying instead on the credit rating agencies as a proxy for risk management and judgement. Credit risk? Or operational risk? The authorities in many countries have introduced plans to make the derivatives markets much more transparent to both participants and regulators, but that solves only part of the problem. Similarly, countries ranging from the EU to India have introduced stricter regulations for the rating agencies, but the abandonment of sensible credit risk management by banks can be seen as an operational risk issue.

There was also the issue of liquidity and the fact that for a long period there was no money – the markets were closed even for the most creditworthy of banks. Basel III has introduced a liquidity coverage (or leverage) ratio to prevent a recurrence, but the closure of the money markets was basically caused by a total breakdown of trust between banks. Again, a behavioural, and therefore an operational risk, rather than a market, liquidity or credit risk issue.

The Dodd-Frank Act was signed into law in July in the US, which aims to restrict banking activities, the subject of the UK’s Banking Commission. Resolution, or ‘living will’, regimes have been established in the UK and US. And then there is Basel III, announced by the Basel Committee in September, which will increase the total capital banks must hold, irrespective of their risk profile, and establish more stringent requirements for both the quality and quantum of Tier 1 capital. Two additional capital buffers were introduced, one a ‘capital conservation’ buffer to protect against times of financial and economic stress and the other a counter-cyclical buffer to protect the banking sector (and thus economies) from periods of excessive credit growth. Basel III eventually comes into full force in 2018 after a period of review and testing, and to allow banks time to raise capital in an orderly fashion for markets.

The problem for the authorities is that fundamentally the crisis was a failure of risk management, or rather a failure to apply risk management at all levels, to understand properly the risks being run and to have a risk governance process in place in which risk management was key and was an accepted challenge to executives’ decisions. And as so much of risk management is about instilling proper risk behaviours and disciplines, risk management failure, the fundamental cause of the crisis, is mainly about people risk, which lies at the heart of operational risk.

Commentators have cited another behavioural weakness, greed, as a cause of the crisis. Greed was certainly there and the EU and FSA are tackling remuneration and incentives in financial services, not just banks. But I prefer to cite herd instinct. Herd instinct lies at the bottom of all bubbles and banking crises. The problem is that although uncertainty is everywhere, we have a strong impulse to believe otherwise and so we seek refuge in behaving as our peer group does. Bankers may not have understood the transactions they were undertaking, but they took reassurance that everybody else was doing it.

So the big question is, will Basel III and the other regulatory initiatives prevent a similar crisis? They may mitigate the effects of a crisis and make the banking sector more robust, but do they address the root cause, failure to apply good risk management? In April, the IMF commented that it was unlikely that all these initiatives, including more intensive supervision, would prevent another financial crisis. I agree, because so much of this and other crises is about people risk and human behaviours.

Unless the culture of many banks change; unless risk management, and especially operational risk management, is genuinely brought into all strategic and operational decisions, we may be back to a crisis sooner than we think.

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