115TH CONGRESS
2d Session

HOUSE OF REPRESENTATIVES

REPORT
115–574

TO PLACE REQUIREMENTS ON OPERATIONAL RISK CAPITAL REQUIREMENTS FOR BANKING ORGANIZATIONS ESTABLISHED BY AN APPROPRIATE FEDERAL BANKING AGENCY

FEBRUARY 23, 2018.—Committed to the Committee of the Whole House on the State of the Union and ordered to be printed

Mr. HENSARLING, from the Committee on Financial Services, submitted the following

REPORT

together with

MINORITY VIEWS

[To accompany H.R. 4296]

[Including cost estimate of the Congressional Budget Office]

The Committee on Financial Services, to whom was referred the bill (H.R. 4296) to place requirements on operational risk capital requirements for banking organizations established by an appropriate Federal banking agency, having considered the same, report favorably thereon with an amendment and recommend that the bill as amended do pass.

The amendment is as follows:

Strike all after the enacting clause and insert the following:

SECTION 1. OPERATIONAL RISK CAPITAL REQUIREMENTS FOR BANKING ORGANIZATIONS.

(a) IN GENERAL.—An appropriate Federal banking agency may not establish an operational risk capital requirement for banking organizations, unless such requirement—

(1) is based primarily on the risks posed by a banking organization's current activities and businesses;

(2) is appropriately sensitive to the risks posed by such current activities and businesses;

(3) is determined under a forward-looking assessment of potential losses that may arise out of a banking organization's current activities, businesses, and exposures, which is not solely based on a banking organization's historical losses; and

(4) permits adjustments based on qualifying operational risk mitigants.

(b) DEFINITIONS.—For purposes of this section:

(1) APPROPRIATE FEDERAL BANKING AGENCY.—The term "appropriate Federal banking agency"—

(A) has the meaning given such term under section 3 of the Federal Deposit Insurance Act; and

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(B) means the National Credit Union Administration, in the case of an insured credit union.

(2) BANKING ORGANIZATION.—The term "banking organization" means—

(A) an insured depository institution (as defined under section 3 of the Federal Deposit Insurance Act);

(B) an insured credit union (as defined under section 101 of the Federal Credit Union Act);

(C) a depository institution holding company (as defined under section 3 of the Federal Deposit Insurance Act);

(D) a company that is treated as a bank holding company for purposes of section 8 of the International Banking Act; and

(E) a U.S. intermediate holding company established by a foreign banking organization pursuant to section 252.153 of title 12, Code of Federal Regulations.

PURPOSE AND SUMMARY

Introduced by Representative Luetkemeyer on November 8, 2017, H.R. 4296 restricts federal banking agencies from establishing operational risk capital requirements for banking organizations unless they are sensitive to, and based on, an organization's current activities or businesses; are determined by a forward-looking assessment of an organization's potential losses and not based solely on its historic losses; and allow for adjustments based on qualifying operational risk mitigants.

BACKGROUND AND NEED FOR LEGISLATION

In response to the 2008 financial crisis, the Basel Committee on Banking Supervision (Basel Committee), of which the United States is a member, agreed to modify internationally negotiated bank regulatory standards known as the Basel Accords to increase bank capital requirements and other regulatory measures. The Basel Accords are international banking regulations negotiated between participating regulators, but they rely on local implementation to take effect in a nation's financial regulatory regime.

The Dodd-Frank Wall Street Reform and Consumer Protection Act (P.L. 111–203) codified the Basel III capital standards and the U.S. federal banking regulators—including the Federal Deposit Insurance Corporation (FDIC), Board of Governors of the Federal Reserve System (Federal Reserve), and Office of the Comptroller of the Currency (OCC)—promulgated rules to implement these standards on July 9, 2013.

As defined by the Basel Committee, operational risk refers to ". . . the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events . . . [t]his definition includes legal risk, but excludes strategic and reputational risk."[1] In other words, a bank's own direct actions or relationships could lead to losses, and therefore should be accounted for by regulators when establishing capital requirements to ensure financial stability.

In October 2013, the OCC, FDIC, and Federal Reserve, in conjunction with the Treasury Department, published a final rule ". . . that requires some and permits other qualifying banks to use an internal ratings-based approach to calculate regulatory credit risk capital requirements and advanced measurement approaches

[1] *https://www.bis.org/publ/bcbs195.pdf.*

to calculate regulatory operational risk capital requirements."[2] The rule took effect on January 1, 2014.

Because operational risk capital requirements substantially dictate a bank's capital levels, it is important that any future Basel approach-turned-U.S. rule does not unnecessarily increase capital requirements at the expense of consumers' credit needs. Unreliable and under-calibrated calculations could result in hundreds of billions of dollars in capital that could be more efficiently deployed to meet consumers' credit needs.

All banking organizations should adopt policies and procedures to identify and manage operational risk that are appropriate based on their size, activities, and product offerings in order to ensure a stable and resilient financial industry. But, requiring banking organizations to "look back" and hold operational risk capital against discontinued business activities or products distorts the risk environment and may force misguided over-retention of capital. This over-retention of capital is a problem because it reduces a bank's lending capacity, which in turn harms both consumers and businesses of all sizes as it drastically limits the amount of available credit in the marketplace.

H.R. 4296 limits the imposition of operational risk capital requirements to a bank's current activities and businesses and permits adjustments for operational risk mitigants. Doing so will ensure that banks have the proper incentives financial to mitigate operational risk, and if a bank exits one or more business lines, the regulatory response does not increase complexity and retain the backward-looking nature of current operational risk capital requirements. H.R. 4296 will ensure a vibrant consumer credit market.

HEARINGS

The Committee on Financial Services held a hearing examining matters relating to H.R. 4296 on April 26, 2017 and April 28, 2017.

COMMITTEE CONSIDERATION

The Committee on Financial Services met in open session on November 14, 2017, and November 15, 2017, and ordered H.R. 4296 to be reported favorably to the House without amendment by a recorded vote of 43 yeas to 17 nays (Record vote no. FC–108), a quorum being present.

COMMITTEE VOTES

Clause 3(b) of rule XIII of the Rules of the House of Representatives requires the Committee to list the record votes on the motion to report legislation and amendments thereto. The sole recorded vote was on a motion by Chairman Hensarling to report the bill favorably to the House without amendment. The motion was agreed to by a recorded vote of 43 yeas to 17 nays (Record vote no. FC–108), a quorum being present.

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[2] *https://www.federalreserve.gov/reportforms/formsreview/BaselIII_20131011_ffr.pdf.*

Record vote no. FC-108

Representative	Yea	Nay	Present	Representative	Yea	Nay	Present
Mr. Hensarling	X			Ms. Maxine Waters (CA)		X	
Mr. McHenry	X			Mrs. Carolyn B. Maloney (NY)	X		
Mr. King	X			Ms. Velázquez		X	
Mr. Royce (CA)	X			Mr. Sherman		X	
Mr. Lucas	X			Mr. Meeks	X		
Mr. Pearce	X			Mr. Capuano		X	
Mr. Posey	X			Mr. Clay		X	
Mr. Luetkemeyer	X			Mr. Lynch		X	
Mr. Huizenga	X			Mr. David Scott (GA)	X		
Mr. Duffy	X			Mr. Al Green (TX)		X	
Mr. Stivers	X			Mr. Cleaver		X	
Mr. Hultgren	X			Ms. Moore		X	
Mr. Ross	X			Mr. Ellison		X	
Mr. Pittenger	X			Mr. Perlmutter		X	
Mrs. Wagner	X			Mr. Himes	X		
Mr. Barr	X			Mr. Foster	X		
Mr. Rothfus	X			Mr. Kildee		X	
Mr. Messer	X			Mr. Delaney	X		
Mr. Tipton	X			Ms. Sinema	X		
Mr. Williams	X			Mrs. Beatty		X	
Mr. Poliquin	X			Mr. Heck		X	
Mrs. Love	X			Mr. Vargas	X		
Mr. Hill	X			Mr. Gottheimer	X		
Mr. Emmer	X			Mr. Gonzalez (TX)		X	
Mr. Zeldin	X			Mr. Crist		X	
Mr. Trott	X			Mr. Kihuen		X	
Mr. Loudermilk	X						
Mr. Mooney (WV)	X						
Mr. MacArthur	X						
Mr. Davidson	X						
Mr. Budd	X						
Mr. Kustoff (TN)	X						
Ms. Tenney	X						
Mr. Hollingsworth	X						

COMMITTEE OVERSIGHT FINDINGS

Pursuant to clause 3(c)(1) of rule XIII of the Rules of the House of Representatives, the findings and recommendations of the Committee based on oversight activities under clause 2(b)(1) of rule X of the Rules of the House of Representatives, are incorporated in the descriptive portions of this report.

PERFORMANCE GOALS AND OBJECTIVES

Pursuant to clause 3(c)(4) of rule XIII of the Rules of the House of Representatives, the Committee states that H.R. 4296 will restrict banking regulators from establishing operational risk capital requirements for banking organizations unless they are sensitive to, and based on, an organization's current activities or businesses; are determined by a forward-looking assessment of an organization's potential losses and not based solely on its historic losses; and allow for adjustments based on qualifying operational risk mitigants.

NEW BUDGET AUTHORITY, ENTITLEMENT AUTHORITY, AND TAX EXPENDITURES

In compliance with clause 3(c)(2) of rule XIII of the Rules of the House of Representatives, the Committee adopts as its own the estimate of new budget authority, entitlement authority, or tax expenditures or revenues contained in the cost estimate prepared by the Director of the Congressional Budget Office pursuant to section 402 of the Congressional Budget Act of 1974.

CONGRESSIONAL BUDGET OFFICE ESTIMATES

Pursuant to clause 3(c)(3) of rule XIII of the Rules of the House of Representatives, the following is the cost estimate provided by the Congressional Budget Office pursuant to section 402 of the Congressional Budget Act of 1974:

U.S. CONGRESS,
CONGRESSIONAL BUDGET OFFICE,
Washington, DC, February 21, 2018.

Hon. JEB HENSARLING,
Chairman, Committee on Financial Services,
House of Representatives, Washington, DC.

DEAR MR. CHAIRMAN: The Congressional Budget Office has prepared the enclosed cost estimate for H.R. 4296, a bill to place requirements on operational risk capital requirements for banking organizations established by an appropriate Federal banking agency.

If you wish further details on this estimate, we will be pleased to provide them. The CBO staff contacts are Kathleen Gramp and Sarah Puro.

Sincerely,

KEITH HALL,
Director.

Enclosure.

H.R. 4296—A bill to place requirements on operational risk capital requirements for banking organizations established by an appropriate Federal banking agency

Summary: H.R. 4296 would direct federal banking regulators to revise one of the formulas used to calculate the minimum amount of capital held by certain large, systemically important banks. Specifically, the bill would change the method banks use to estimate operating risk—the risk of losses stemming from inadequate or failed internal controls, fraud or errors caused by people and systems, or external events such as cyberattacks. Regulators currently require banks to estimate operating risk based in part on historical experience. Under the bill, such risk would be calculated largely on the basis of forward-looking models that reflect each bank's business activities.

CBO estimates that enacting H.R. 4296 would increase the deficit by $22 million over the 2018–2027 period. That figure includes an increase of $26 million in direct spending and an increase of $4 million in revenues. Because enacting the bill would affect direct spending and revenues, pay-as-you-go procedures apply.

CBO estimates that enacting H.R. 4296 would not increase net direct spending or on-budget deficits by more than $2.5 billion in one or more of the four consecutive 10-year periods beginning in 2028.

H.R. 4296 contains no intergovernmental or private-sector mandates as defined in the Unfunded Mandates Reform Act (UMRA).

Estimated cost to the Federal Government: The estimated budgetary effect of H.R. 4296 is shown in the following table. The costs of the legislation fall within budget function 370 (advancement of commerce).

	By fiscal year, in millions of dollars—											
	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027	2018–2022	2018–2027
INCREASES IN DIRECT SPENDING												
Estimated Budget Authority	0	1	2	3	4	4	3	3	3	3	10	26
Estimated Outlays	0	1	2	3	4	4	3	3	3	3	10	26
INCREASES IN REVENUES												
Estimated Revenues	0	0	0	0	0	0	1	1	1	1	0	4
NET INCREASE IN THE DEFICIT FROM INCREASES IN DIRECT SPENDING AND REVENUES												
Effect on the Deficit	0	1	2	3	4	4	2	2	2	2	10	22

Basis of estimate: The budgetary effects of the bill stem from the small chance that the Federal Deposit Insurance Corporation (FDIC) would incur additional costs to resolve failed financial institutions. For this estimate, CBO assumes that the bill will be enacted near the end of 2018.

CBO's estimates for H.R. 4296 are based on the analysis underlying the projections for deposit insurance in its June 2017 baseline. Those projections incorporate a small probability of a financial crisis in any given year during the projection period and the more likely scenario of an average number of bank and credit union failures in any given year. As a result, the estimated cost of this legislation represents a weighted probability of outcomes—including some cases for which the probability is very low but for which the costs to the Deposit Insurance Fund (DIF) or the Orderly Liquidation Fund (OLF) are much larger than in average years. Costs incurred by the DIF are recovered over time by assessments on insured depository institutions (IDIs). Fees paid to recover costs incurred by the OLF are classified in the budget as revenues. Both funds are administered by the FDIC.

CBO anticipates that the directives in H.R. 4296 would apply to around 10 bank holding companies and their insured depository subsidiaries that currently estimate capital requirements using what the FDIC refers to as advanced approaches. The net effect of implementing the bill would vary among those institutions because the measure that reflects operating risks is only one of many methods used by federal regulators to determine how much capital a bank must hold.[1] CBO estimates that in fiscal year 2017, the advanced-approaches formula was used to determine capital requirements for companies that accounted for about 20 percent of the assets held by bank holding companies subject to that standard and for about 5 percent of the assets held by IDIs.

Using studies by the Federal Reserve and others, CBO anticipates that changing to forward-looking models as required by H.R. 4296 probably would lower firm's estimates of their operating risks, thereby lowering the amount of capital they would be required to hold.[2] Although there is considerable uncertainty surrounding the magnitude of such changes, CBO expects that the net change would be limited to the difference in capital identified by the new method and that identified by existing regulatory formulas. On balance, CBO estimates that, relative to current practice, enacting the bill would reduce the total capital held by the all of the large bank holding companies by less than 2 percent and for the IDIs subject to the standard by less than 0.5 percent.

Changes in a bank's capital requirements may affect its probability of failure or the magnitude of future losses, which in turn may affect costs incurred by the DIF or the OLF. Most of the costs of enacting the legislation would be incurred by the OLF, CBO estimates, because enacting the bill would have a greater effect on the capital held by bank holding companies. (The OLF is authorized to resolve financial difficulties for large, systemically important financial firms that become insolvent or are in danger of becoming insolvent.) CBO estimates that enacting the bill would increase the deficit by $22 million, or by roughly 0.03 percent of CBO's June baseline projection of the 10-year cost of the FDIC's programs. That amount includes an increase in direct spending of $26 million and an increase of revenues of $4 million. CBO estimates that most of those costs would be offset after 2027 by increases in fees paid by financial firms.

Pay-As-You-Go considerations: The Statutory Pay-As-You-Go Act of 2010 establishes budget-reporting and enforcement procedures for legislation affecting direct spending or revenues. The net changes in outlays and revenues that are subject to those pay-as-you-go procedures are shown in the following table.

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[1] Regulators use several other methods of assessment, including information on a bank's standard measure of risk-weighted assets, a bank's assets adjusted for off-balance sheet activities, and the level of assets needed to absorb losses during times of stress.

[2] See Marco Migueis, *Forward-Looking and Incentive-Compatible Operational Risk Capital Framework,* Finance and Economics Discussion Series 2017–087 (Federal Reserve Board, May 2017), *https://doi.org/10.17016/FEDS.2017.087* (PDF, 383 KB).

CBO ESTIMATE OF PAY-AS-YOU-GO EFFECTS FOR H.R. 4296, AS ORDERED REPORTED BY THE HOUSE COMMITTEE ON FINANCIAL SERVICES ON NOVEMBER 15, 2017

	By fiscal year, in millions of dollars—											
	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027	2018–2022	2018–2027
NET INCREASE IN THE ON-BUDGET DEFICIT												
Statutory Pay-As-You-Go Impact	0	1	2	3	4	4	2	2	2	2	10	22
Memorandum:												
Changes in Outlays	0	1	2	3	4	4	3	3	3	3	10	26
Changes in Revenues	0	0	0	0	0	0	1	1	1	1	0	4

Increase in long-term direct spending and deficits: CBO estimates that enacting the legislation would not increase net direct spending or on-budget deficits by more than $2.5 billion in any of the four consecutive 10-year periods beginning in 2028.

Mandates: H.R. 4296 contains no intergovernmental or private-sector mandates as defined in UMRA.

Previous CBO estimate: On May 18, 2017, CBO transmitted a cost estimate for H.R. 10, the Financial CHOICE Act, as ordered reported by the House Committee on Financial Services on May 4, 2017. H.R. 4296 is identical to section 152 of H.R. 10. The CBO cost estimates are different for this provision, however, because H.R. 10 also would eliminate the OLF. As a result, CBO's cost estimate for section 152 of H.R. 10 did not include any costs to the OLF.

Estimate prepared by: Federal costs: Kathleen Gramp and Sarah Puro; Mandates: Rachel Austin.

Estimate approved by: H. Samuel Papenfuss; Deputy Assistant Director for Budget Analysis.

FEDERAL MANDATES STATEMENT

This information is provided in accordance with section 423 of the Unfunded Mandates Reform Act of 1995.

The Committee has determined that the bill does not contain Federal mandates on the private sector. The Committee has determined that the bill does not impose a Federal intergovernmental mandate on State, local, or tribal governments.

ADVISORY COMMITTEE STATEMENT

No advisory committees within the meaning of section 5(b) of the Federal Advisory Committee Act were created by this legislation.

APPLICABILITY TO LEGISLATIVE BRANCH

The Committee finds that the legislation does not relate to the terms and conditions of employment or access to public services or accommodations within the meaning of the section 102(b)(3) of the Congressional Accountability Act.

EARMARK IDENTIFICATION

With respect to clause 9 of rule XXI of the Rules of the House of Representatives, the Committee has carefully reviewed the provisions of the bill and states that the provisions of the bill do not contain any congressional earmarks, limited tax benefits, or limited tariff benefits within the meaning of the rule.

DUPLICATION OF FEDERAL PROGRAMS

In compliance with clause 3(c)(5) of rule XIII of the Rules of the House of Representatives, the Committee states that no provision of the bill establishes or reauthorizes: (1) a program of the Federal Government known to be duplicative of another Federal program; (2) a program included in any report from the Government Accountability Office to Congress pursuant to section 21 of Public Law 111–139; or (3) a program related to a program identified in the most recent Catalog of Federal Domestic Assistance, published pursuant to the Federal Program Information Act (Pub. L. No. 95–220, as amended by Pub. L. No. 98–169).

DISCLOSURE OF DIRECTED RULEMAKING

Pursuant to section 3(i) of H. Res. 5, (115th Congress), the following statement is made concerning directed rulemakings: The Committee estimates that the bill requires no directed rulemakings within the meaning of such section.

SECTION-BY-SECTION ANALYSIS OF THE LEGISLATION

Section 1. Operational risk capital requirements for banking organizations

This section prohibits a Federal banking agency from establishing an operational risk capital requirement for banking organizations, unless such a requirement:

(1) is based primarily on the risks posed by a banking organization's current activities and businesses;

(2) is appropriately sensitive to the risks posed by such current activities and businesses;

(3) is determined under a forward-looking assessment of potential losses that may arise out of a banking organization's current activities, businesses, and exposures, which is not solely based on a banking organization's historical losses; and

(4) permits adjustments based on qualifying operational risk mitigants.

This section also defines the various terms utilized within the Act.

CHANGES IN EXISTING LAW MADE BY THE BILL, AS REPORTED

H.R. 4296 does not repeal or amend any section of a statute. Therefore, the Office of Legislative Counsel did not prepare the report contemplated by clause 3(e)(1)(B) of rule XIII of the Rules of the House of Representatives.

MINORITY VIEWS

H.R. 4296 would place new, statutory conditions on how regulators implement a specific capital requirement relating to operational risk, and if the conditions are not satisfied, then the capital requirement would be prohibited. Operational risk capital is required to be held by a dozen or so of our largest, internationally-active megabanks. And, it relates to operational risks, such as legal liability and operational breakdowns of these megabanks. These operational failures include JPMorgan's "London Whale" trades and Wells Fargo's long list of violations that have ripped off millions of consumers, including those harmed by their fraudulent account scandal.

These same large Wall Street banks would benefit from changes to this capital requirement, which cause harm not only to consumers but the broader economy. According to Stanford professor, Anat Admati, "the fines banks paid in the past may well be indicative of future risk. There are enormous rates of recidivism in corporate misconduct."

According to a letter submitted to the Committee opposing H.R. 4296 as a big bank giveaway, Americans for Financial Reform wrote, "operational risk capital is a new capital protection instituted at banks with over $250 billion in assets, to protect against the possibility that poor risk management or illegal behavior by bank employees will cause significant losses." These critical areas, include past and present cyber risk, rogue traders, risk management, and legal judgements. In conclusion, AFR wrote, "HR 4296 is a transparent attempt to pressure regulators to reduce capital protections at the nation's largest banks, and must be rejected."

Furthermore, according to bank regulators and the Treasury Department, efforts have been underway internationally to make administrative and technical refinements to the operational risk capital requirement, and we should expect changes in the near future. Congress should closely monitor these developments to see if regulators strike the right balance, and if not, then consider a legislative response.

Thus, H.R. 4296 is premature and possibly short-sighted to enact statutory conditions regarding the operational risk capital requirement. This framework would diminish, instead of strengthen, the incentive for megabanks to maintain stronger internal controls and risk management systems.

After all, there has been tremendous progress since the financial crisis of 2007–2009 to create a far better capitalized banking system. As required by the Dodd-Frank Act—and in implementing the international Basel III capital accords—our banking regulators have required banks to maintain more and higher quality capital. Republicans have long argued that these financial reforms would crush lending and harm banks and the broader economy. However, the facts tell a different story. Bank profits reached an all-time record high in 2016 and business lending is up 75 percent since 2010. All this has happened while U.S. banks added more than $700 billion in capital to absorb potential losses. According to Third Way, these reforms, including capital rules that have made our financial system safer, are estimated to add $351 billion to the U.S. economy over 10 years.

For these reasons, we oppose H.R. 4296.

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