Operational Risk
and
Consolidated Supervised Entities

THE BROKER-DEALER

Background on Consolidated Supervised Entities

- A broker-dealer that meets certain minimum requirements may apply to become a consolidated supervised entity (“CSE”) and use an alternative method of computing net capital
- The alternative method of computing net capital permits a broker-dealer to use internal models to calculate its market risk charges and derivatives-related credit risk charges
- The alternative method of computing net capital is not a Basel capital calculation

Operational Risk Charges in the Broker-Dealer

- A broker-dealer that is part of a CSE will not be subject to a Basel operational risk charge
- The SEC’s financial responsibility rules, however, always have reflected the need to account for operational risks
- The Net Capital Rule includes operational risk charges (these charges have been in place since 1975), some of which will be addressed in the following slides

Operational Risk Charges in the Broker-Dealer

- Certain items that arise in the course of operations are subject to a capital charge, such as:
  - Aged failed to delivers
  - Short securities differences
  - Suspense account items (essentially securities transactions that cannot be completed for various reasons
  - Reconciliation differences (unfavorable bank account, correspondent account, clearing corporation and securities depository reconciliation differences

Operational Risk Charges in the Broker-Dealer

- The charges that a broker-dealer must take are reflected in the reports it files with the SEC (FOCUS report)

Operational Risk Charges in the Broker-Dealer

- Under the net capital rule, a broker-dealer must take certain capital charges that are not necessarily related to asset risk
- For example, a broker-dealer computing net capital under the alternative method effectively must maintain net capital equal to 5% of aggregate debit items (rather than the 2% ration contained in the rule) because persons associated with the broker-dealer cannot withdraw equity capital if the withdrawal would cause its net capital to fall below 5% of aggregate debit items

THE ULTIMATE HOLDING COMPANY

Background
Consolidated Supervised Entities

- As a condition to its use of the alternative method of computing net capital, the broker-dealer must provide the SEC with an undertaking in which the ultimate holding company agrees to consolidated, group-wide supervision by the SEC

Background
Consolidated Supervised Entities

- The CSE must compute allowable capital, which is a Basel capital calculation, on a consolidated, group-wide basis,
- The allowable capital calculation includes an allowance for operational risk

Allowance for Operational Risk - Rules

- The CSE (ultimate holding company) must comply with SEC Rule 15c3-4
- Under this rule, the CSE must establish, document and maintain a system of internal risk management controls
- A CSE must have a risk control unit that reports directly to senior management and is independent from business trading units
- The CSE must make and keep records related to its system of internal risk management controls

Allowance for Operational Risk - Rules

- The SEC staff reviews operations as part of the CSE application process, including recordkeeping, risk management and internal audit
- The SEC staff will rely upon the CSE internal audit departments

CSEs and Basel

- Entities that are approved as CSEs or will be approved as CSEs generally are calculating allowable capital under Basel II
- CSEs initially are or will be using the Basic Indicator Approach to calculating operational risk
- Most CSEs will transition to a different method of calculating operational risk

CSEs and Basel

- CSEs must begin:
  - Identifying indicators of risk
  - Collecting data
  - Classifying indicators of risk
  - Collecting outliers

Operational Risk Challenges

- Adequacy of data
- Identification of tail events and loss distributions