THE RISK MANAGEMENT ASSOCIATION
Serving the Financial Services Industry

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February 25, 2011

Secretariat
Basel Committee on Banking Supervision
Bank for International Settlements
CH – 4002
Basel, Switzerland

Response to Supervisory Guidance and Sound Practices Consultative Documents

Dear Sir or Madam:

I am writing on behalf of the Advanced Measurement Approaches Group (AMAG)[1] in the United States in response to your Consultative Documents *entitled Operational Risk – Supervisory Guidelines for the Advanced Measurement Approaches* and *Sound Practices for the Management and Supervision of Operational Risk* dated December 2010.

Our group supports the AMA and its fundamental goals of improving operational risk management practices and enhancing capital adequacy. We, therefore, applaud your work toward the recognition of sound and effective practices and identification of convergences within the operational risk management discipline.

Members of AMAG are in agreement with many of the guidelines outlined in both of the Consultative Documents. The AMAG believes that they represent a thoughtful reflection of progress by industry participants. As one might expect, however, the AMAG has comments about specific issues covered in the Documents. So, in the spirit of advancing the dialogue between the industry and regulatory

[1] The Advanced Measurement Approaches Group (AMAG) was formed in 2005 to share industry views on aspects of Advanced Measurement Approaches (AMA) implementation with the U.S. financial services federal regulatory agencies. The members of AMAG are listed in Attachment C to this letter. They are listed for identification purposes only. This letter and attachments do not necessarily represent the views of RMA's institutional membership at large, or the views of the individual institutions whose staff have participated in the AMAG.

community AMAG offers a number of specific observations and requests for improving them, along with the regulatory expectations outlined therein. AMAG believes that many of these issues can be considered and addressed for improvement, without diminishing rigor.

We enclose these more specific comments as Attachment A -- AMAG Response to Sound Practices Consultative Document and Attachment B -- AMAG Response to Supervisory Guidelines Consultative Document.

Thank you for the opportunity to comment on the Consultative Documents.

Sincerely,

Robin L. Phillips
Chairman, AMA Group

Attachments:

A – AMAG Response to Sound Practices Consultative Document
B – AMAG Response to Supervisory Guidelines Consultative Document
C – About the AMAG

Attachment A:

AMAG Response to SIGOR Sound Practices Consultative Document –

Commentary on Specific Sections

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AMAG Response to SIGOR Sound Practices Consultative Document –

Commentary on Specific Sections

This paper outlines specific comments from the AMAG on the Sound Practices Consultative Document. In each case, the relevant passage from the Document is provided (bold text), followed by AMAG commentary and, where applicable, suggested revisions.

A.1 Operational Risk Committees

(Excerpt from the Sound Practices p. 10, par. 37) –

"37. A bank's governance structure should be commensurate with the nature, size, complexity and risk profile of its activities. When designing the operational risk governance structure, a bank should take the following into consideration:

"(a) Committee structure – Sound industry practice for larger and more complex organisations with a central group function and separate business units is to utilise a board-created enterprise level risk committee for overseeing all risks, to which a management level operational risk committee reports. Depending on the nature, size and complexity of the bank, the enterprise level risk committee may receive input from operational risk committees by country, business or functional area. Smaller and less complex organisations may utilise a flatter organisational structure that oversees operational risk directly within the board's risk management committee;

"(b) Committee composition – Sound industry practice is for operational risk committees (or the risk committee in smaller banks) to include a combination of members with expertise in business activities, financial or risk management expertise and independent non-executive board members …"

AMAG Response Commentary:

> AMAG agrees that governance structures should be commensurate with a bank's risk profile, and indeed that the engagement of senior management is a critical factor. The structure and organization of operational risk governance across AMAG banks varies, in particular with respect to its integration with other risk disciplines. In some firms, for instance, risk committees at business level oversee all risks within their respective businesses, and are the vehicles for enterprise level reporting. With regard to Guidance 37(a), AMAG believes that rather than mandate the existence of an operational risk committee reporting to an enterprise level risk committee, SIGOR should recognize alternative structures that achieve the objective of sound governance.
>
> AMAG also believes that with regard to composition of a firm's operational risk committee (guideline 37(b)), rather than mandate the presence of non-executive board members on an institution's operational risk committee, the SIGOR should provide firms with discretion to implement alternative governance approaches that would be effective relative to a bank's risk profile.

AMAG Requested Revision:

> AMAG requests that the phrase "to which a management level operational risk committee reports" be stricken from paragraph 37(a), instead resulting in the shortened sentence, "Sound industry practice for larger and more complex organisations with a central group function and separate business units is to utilise a board-created enterprise level risk committee for overseeing all risks."

A.2 Operational Risk Appetite and Tolerance

(Excerpts from the Sound Practices pp. 1-2, par. 4 and p. 9, par. 30) –

"4. Supervisors will continue to encourage banks "to move along the spectrum of available approaches as they develop more sophisticated operational risk measurement systems and practices".2 Consequently, while this paper articulates principles from emerging sound industry practice, supervisors expect banks to continuously improve their approaches to operational risk management. In addition, this paper addresses key elements of a bank's Framework. These elements should not be viewed in isolation but should be integrated components of the overall framework for managing operational risk across the enterprise."

"30. When establishing and approving a risk appetite and tolerance statement, the board of directors should consider all relevant risks, the bank's level of risk aversion, its current financial condition and the bank's strategic direction. The risk appetite and tolerance statement should encapsulate the various operational risk appetites within a bank and ensure that they are consistent. The board of directors should approve appropriate thresholds or limits for specific operational risks, and an overall operational risk appetite and tolerance."

AMAG Response Commentary:

> Quantifying a definite operational risk appetite is challenging inasmuch as an operational risk framework seeks to quantify exposure to large, unexpected losses. The AMAG senses a broad range of practice in the industry on the quantification of operational risk tolerance. AMAG believes that SIGOR should continue to allow discretion by institutions regarding the scope of the operational risk appetite statement as well as the practices for the implementation of this component of the framework.

AMAG Requested Revision:

> No specific wording changes requested.

Attachment B:

AMAG Response to SIGOR Supervisory Guidance Consultative Document –

Commentary on Specific Sections

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AMAG Response to SIGOR Supervisory Guidance Consultative Document –

Commentary on Specific Sections

This paper outlines specific comments from the AMAG on the Supervisory Guidance Consultative Document. They are presented in order of those concerns cited by the greatest number of members. In each case, the relevant passage from the Document is provided (bold text), followed by AMAG comments and, where applicable, suggested revisions.

B.1 Scenario Analysis

(Excerpts from the Supervisory Guidance pp. 49-50, par. 255-257) –

"255. A robust scenario analysis framework is an important element of the ORMF. This scenario process will necessarily be informed by relevant ILD, ED and suitable measures of BEICFs. While there are a variety of integrated scenario approaches, the level of influence of scenario data within these models differs significantly across banks.

"256. The scenario process is subjective by nature and therefore the outputs from a scenario process necessarily contain significant uncertainties. This uncertainty, together with the uncertainty from the other elements, should be reflected in the output of the model producing a range for the capital requirements estimate. Thus, scenario uncertainties provide a mechanism for estimating an appropriate level of conservatism in the choice of the final regulatory capital charge. Because quantifying the uncertainty arising from scenario biases continues to pose significant challenges, a bank should closely observe the integrity of the modelling process and engage closely with the relevant supervisor.

"257. Scenario data provides a forward-looking view of potential operational risk exposures. It also provides a mechanism for incorporating the operational risk exposure of business decisions (for example, assessing the risk of undertaking a new project). A robust governance framework surrounding the scenario process is essential to ensure the integrity and consistency of the estimates produced. Supervisors will generally observe the following elements in an established scenario framework:

> **"(a) A clearly defined and repeatable process;**
> **(b) Good quality background preparation of the participants for the scenario generation workshop;**
> **(c) Qualified and experienced facilitators with consistency in the facilitation process;**
> **(d) The appropriate representatives of the business, subject matter experts and the corporate operational risk management function as participants involved in the workshop;**
> **(e) A structured process for the selection of data used in developing scenario estimates;**
> **(f) High quality documentation which provides clear reasoning and evidence supporting the scenario output;**
> **(g) A robust independent challenge process and oversight by the corporate operational risk management function to ensure the appropriateness of scenario estimates;**
> **(h) A process that is responsive to changes in both the internal and external environment; and**
> **(i) Mechanisms for mitigating biases inherent in scenario processes. Such biases include anchoring, availability and motivational biases."**

(Excerpt from the Sound Practices p. 11, par. 39(f) –

"Scenario Analysis: Scenario analysis is a process of obtaining expert opinion of business line and risk managers to identify potential operational risk events and assess their potential outcome. Scenario analysis is an effective tool to consider potential sources of significant operational risk and the need for additional risk management controls or mitigation solutions. Given the subjectivity of the scenario process, a robust governance framework is essential to ensure the integrity and consistency of the process"

AMAG Response Commentary:

AMAG recognizes and appreciates SIGOR's attempts at convergence and international consistency through promulgation of the Sound Practices and Supervisory Guidance documents. Members find, however, that as a result of ambiguity toward scenario analysis applications and its relatively limited treatment in the Supervisory Guidance document, banks in certain jurisdictions may be subjected to an unlevel playing field.

In addition, the paper should recognize that the Scenario Analysis methodology may differ according to whether a bank uses an LDA or Scenario-based approach (SBA) to AMA. Differing objectives (e.g. synthetic data creation, validation, or used to inform the distributional assumptions, etc.) will significantly impact the exact methodology of scenario analysis. Some AMAG members would also like to retain the flexibility of using scenarios as an input into models in appropriate circumstances. For example, it should also be recognized that Scenario Analysis, particularly for LDA banks, is not necessarily a direct input into AMA, but serves as a tool to assess the appropriateness of distributional assumptions and capital estimates by considering the impact of plausible extreme events including those that the industry has not experienced before (i.e., not reflected in the internal or external datasets).

Note: because of ambiguity on this subject AMAG will endeavor in the coming months to define acceptable ranges of practice in the area for potential adoption by its members.

AMAG Suggested Revision:

No specific wording changes requested.

B.2 Internal Expenses

(Excerpt from the Supervisory Guidance p. 21, sec. 85(b)) –

"85. The following specific items should be *included* in gross loss computation:

"… (b) Costs incurred as a consequence of the event that should include internal and external expenses with a direct link to the operational risk event and costs of repair or replacement, to restore the position that was prevailing before the operational risk event (eg legal expenses directly related to the event and fees paid to advisors, attorneys or suppliers). "

AMAG Response Commentary:

The AMAG points to previous discussions with the regulatory community on these expense categories. AMAG is opposed to including Internal Expenses for the following reasons: (a) Institutions should not need to hold capital for recurring business expenses; (b) there is a wide range of practice in cost accounting that would make collection of data wholly inconsistent across institutions even assuming that a definition could be standardized; and (c) the burden of data collection would be onerous since internal costs of this nature are not managed in a way that would associate them with individual loss events, requiring substantive new procedures to be implemented.

AMAG Requested Revision:

AMAG requests that the words "Internal and" be stricken from the document and the parenthetical be moved to after "External Expenses". Thus, the resultant language would be "…should include external expenses (e.g., legal expense directly related to the event and fees paid to advisors, attorneys or suppliers) with a direct link to the ...."

B.3 Dependence

(Excerpts from the Supervisory Guidance pp. 42-44, sec. 225 to 238) –

"225. Paragraph 669(d) of the Basel II Framework states that, "*Risk measures for different operational risk estimates must be added for purposes of calculating the regulatory minimum capital requirement. However, the bank may be permitted to use internally determined correlations in operational risk losses across individual operational risk estimates, provided it can demonstrate to the satisfaction of the national supervisor that its systems for determining correlations are sound, implemented with integrity and take into account the uncertainty surrounding any such correlation estimates (particularly in periods of stress). The bank must validate its correlation assumptions using appropriate quantitative and qualitative techniques….*.

"231. Dependence assumptions should be supported by empirical analysis of internal and external loss data where appropriate….

"232. Dependence assumptions should also reflect the judgment of business line experts. Using judgment for dependence may present its own challenges, as eliciting accurate but subjective estimates may be more difficult in the multivariate context than in the univariate context."

AMAG Response Commentary:

AMAG developed and shared with U.S. supervisory agencies a paper on Unit of Measure and Dependence in 2008. We argued then and continue to believe that dependence should be shown by empirical analysis and judgment when possible, but banks should be allowed to show empirical analysis or logic / judgment where the facts of a case are patently obvious.

Following is an excerpt of that 2008 AMAG paper:

"AMAG Industry Position on Diversification:
Estimates of dependence and independence between losses in different Units of Measure should be well-supported logically *<u>and/or</u>* *statistically….(emphasis added)*

"Firms should be able to demonstrate how dependence between units of measure is incorporated into exposure estimates; given the short time horizon of loss collection and data scarcity in general, however, it would be premature and unreasonable to expect firms to validate these methodologies and assumptions with statistical analysis rigorously, supported by sufficient data sample sizes.

"Flexibility is key for firms' choice of methodologies and assumptions that support their dependence structure (e.g. whether to use a standard matrix transformation or a copula, if a copula is used which type of copula, and the values applied for correlation coefficients). Firms' dependence structures should be assessed based on the combined or aggregate affect of the methodologies and assumptions and not on any one element of the structure in isolation. There are multiple factors that affect the level of dependence between units of measure including the number of units of measure, whether the dependence is between frequency, severity or aggregate losses, and the value applied to the correlation coefficient. In the end, the approach selected should be supported by documentation that evidences the thought process that drove decisions about its viability and use.

<u>"Logical arguments for independence:</u> Failures in different processes supporting different businesses in different regions serving different customers and supported by different information technology (IT) and human resource (HR) systems, do not seem likely to be dependent on one another, even in extreme situations. This is an example of a strong logical argument for assuming independence between losses in different Units of Measure that does not require significant additional statistical support. Judgment will be supported by data, when and where available. Where the logic for arguing independence is strong and there is no statistical evidence to the contrary, however, firms should be allowed to assume that risks are independent between Units of Measure in estimating minimum capital requirements using the AMA…." (from 2008 AMAG Position Paper on Unit of Measure and Dependence, available at:
http://www.rmahq.org/NR/rdonlyres/BD16202F-A296-4191-88B9-77917156D1B3/0/AMAG_IPP_UoMD_2008.pdf)

In addition, more recently a member has recently commented on Supervisory Guideline 232 that business representatives may not possess the expertise to opine on the appropriateness / accuracy of dependence without conducting a significant amount of research / testing, which would result in a significant investment of effort. In cases where dependence can be supported entirely by data and statistical proof alone, such proof should suffice in the absence of other research-based judgment..

AMAG Requested Revisions:

- Revise the last sentence in paragraph 225 to read: "…using appropriate quantitative <u>and / or</u> qualitative techniques"

- Revise the end of the first sentence in paragraph 231 to read: "…loss data where appropriate <u>and available</u>…"
- Revise the first sentence of Section 232 to read: "Dependence assumptions <u>may also</u> reflect the judgment…."

<u>B.4 Legal Reserves</u>

(Excerpts from the Supervisory Guidance pp. 28-29, sec. 128 to 139) –

"128. The collection of numerous dates does not represent a concern from an operational risk management perspective, as each reference date offers potentially different information on the characteristics of each loss. A bank should not select a reference date for quantification that results in the omission of large internal losses as this can have a significant impact on the bank's operational risk capital charge. Due to the potential for material differences in capital requirement levels for similar risk exposures, supervisors are encouraging convergence of practice in the way losses are treated and recorded as operational risk loss events. This issue is particularly relevant for institutions that use the occurrence date to build their calculation dataset, and in regions where legal losses represent a material amount of all losses.

"129. These guidelines are designed to encourage more consistency to AMA models and more harmony to AMA implementation in different jurisdictions for building a calculation dataset.

"130. A bank may use any of the reference dates (occurrence date, discovery date, contingent liability date or accounting date) for building its calculation dataset, and for meeting minimum observation period requirements as long as material loss data is not omitted. No other dates are acceptable for building a calculation dataset….

"133. Consistent with other operational risk losses, a bank should use a date no later than the date of reserve (accounting date) for including legal related losses/exposures as an input in its AMA model.

"134. Differences as to when legal losses are recognised may impact the measurement of operational risk exposure for similar events. Consequently a bank should follow the principle of conservatism when considering the inputs in its AMA model. Given the time lag between the a legal proceeding and its conclusion, a date that is no later than the date for establishment of a legal reserve provides consistency and conservatism and more effectively reflects the bank's operational risk profile.

"135. Because a legal exposure can change over time, a bank should include legal events as scenarios in the interim. That is, from discovery date until the date of accounting of the legal reserve, these events are recognised potential exposures that may potentially impact the bank's operational risk profile. A bank should also implement a robust process for updating legal event exposures between the reserve date and settlement date.

"137. The diverse use of dates for quantification purposes raises questions as to whether a bank's operational risk profile quantification properly reflects all known operational risk exposures. The example above clearly illustrates that a bank that uses settlement date rather than accounting date may in fact omit a material exposure for an extended time period.

"138. Date of reserve is a sensible option for improving industry convergence because the loss exposure is reasonably estimated and it can be reconciled to the general ledger. Convergence would likely ensure that similar legal exposures across banks do not materially differ in the determination of a bank's calculation dataset.

"139. Supervisors understand industry concerns that including legal events in the loss database prior to settlement may lead to an increase in the frequency and severity of legal settlements. Several banks continue to raise this matter contending that the loss data and accompanying descriptive information could be revealed through the discovery process in a legal proceeding, thereby increasing the likelihood and magnitude of an adverse outcome. However, this concern lacks credibility, as many banks have developed processes to provide information on legal events that support their AMA modelling methodology without disclosing confidential data. As a result, a bank should capture all known legal-related exposures in its operational risk measurement and management systems."

AMAG Response Commentary:

AMAG's 2010 ROP survey produced evidence of a broad range of practice in the recording of legal reserves in data for modeling, with strong arguments for alternative approaches. Most members believe that inclusion of reserves is entirely appropriate, either as direct input at the time a reserve is established or as indirect input to models through scenario analysis. A number of members believe that recording of litigation events in operational risk data prior to settlement may increase the likelihood of discovery. A few believe that reserves should be excluded entirely given the inherent difficulty in estimating exposure.

In addition, the proposed guidelines outlined in sections 128 through 139 do not adequately distinguish between general legal exposures resulting from operational risk events and those that are litigation-related operational losses where a reserve has been taken that should be considered as a direct or indirect input for capital modeling purposes. The supervisory guidance should clarify that banks should capture exposures only for litigation-related operational loss events for which a reserve has been taken. At a minimum, AMAG members request a revision to paragraph 133 (see below).

Furthermore, AMAG disagrees with the statement in paragraph 139 that banks' concern regarding discovery of privileged data "lacks credibility." In common law jurisdictions, such as the United Kingdom and the United States, where parties to litigation are subject to extensive discovery obligations, this is a very real concern. Therefore, at a minimum, AMAG requests that the language be eliminated, and further that the last sentence be revised to clarify the use of loss reserve data for modeling purposes (see below).

AMAG Requested Revisions:

- AMAG requests that paragraph 133 be revised to replace the word "legal" with "litigation", as follows: "Consistent with other operational risk losses, a bank should use a date no later than the date of reserve (accounting date) for including ~~legal~~ litigation-related operational losses/exposures for which reserves have been taken as an input in its AMA model." (edits shown for clarity)

- AMAG requests that paragraph 139 be revised, as follows: "Supervisors understand industry concerns that including legal events in the loss database prior to settlement may lead to an increase in the frequency and severity of legal settlements. Several banks continue to raise this matter contending that the loss data and accompanying descriptive information could be revealed through the discovery process in a legal proceeding, thereby increasing the likelihood and magnitude of an adverse outcome. However, ~~this concern lacks credibility, as~~ many banks have developed processes to provide information on legal events that support their AMA modeling methodology without disclosing confidential data. As a result, <u>for capital modeling purposes,</u> a bank should capture ~~all known legal~~ <u>litigation</u>-related <u>operational</u> exposures <u>for which reserves have been taken</u> ~~exposures in its operational risk measurement and management systems~~." (edits shown for clarity)

<u>B.5 Statistical Bias</u>

(Excerpts from the Supervisory Guidance p. 39, sec. 203 and p.49, sec 254) –

"203. When estimating the parameters of the distribution, a bank should avoid potential biases by taking into account the incompleteness of the calculation dataset in the model (e.g., due to the presence of de minimis modelling threshold(s) which may or may not coincide with the data collection threshold). The bank should provide evidence that an incomplete calculation dataset does not adversely impact the credibility and accuracy of the parameter estimates and capital requirements."

"254. As ED may not necessarily fit a particular bank's risk profile, a bank should have a defined process to assess relevancy and to scale the loss amounts as appropriate. A data filtering process involves the selection of relevant ED based on specific criteria and is necessary to ensure that the ED being used is relevant and consistent with the risk profile of the bank. To avoid bias in parameter estimates, the filtering process should result in consistent selection of data regardless of loss amount. If a bank permits exceptions to its selection process, the bank should have a policy providing criteria for exceptions and documentation supporting the rationale for any exceptions. A data scaling process involves the adjustment of loss amounts reported in external data to fit a bank's business activities and risk profile. Any scaling process should be systematic, statistically supported, and should provide output that is consistent with the bank's risk profile."

AMAG Response Commentary:

The use of the term bias implies a degree of rigor that cannot be achieved.

Paragraphs 203 and 254 of the document use the word "bias" in relation to estimating the parameters of a severity distribution. The fundamental problem presented by these paragraphs is the presumption of a method to assess bias. Any assessment of bias requires knowing the "true" distribution with certainty. Therefore, paragraphs 203 and 254 leave regulators and practitioners with the unachievable objective of avoiding bias.

The ability to assess bias requires knowing the functional form of the "true" distribution with certainty. Pindyck and Rubinfeld note that in practice this knowledge is never available.

"Our discussion of econometrics has relied heavily on the assumption that the model to

be estimated is correctly specified. Once the correct specification of the model is *assumed,* model estimation and model testing become relatively straightforward***.*** *In reality, however, we can never be sure that a given model is correctly specified. In fact, researchers usually examine more than one possible specification, attempting to find the specification which best describes the process under study.*" (Pindyck and Rubinfeld, 4th Edition, 184 [emphasis added])

Paragraphs 203 and 254 should, therefore, at a minimum be rewritten to eliminate the notion of bias, or stricken altogether.

AMAG Requested Revision:

AMAG requests that SIGOR delete the words "avoid potential biases by taking" from the first sentence of paragraph 203 and replace them with "take". Thus, the wording would become "When estimating the parameters of the distribution, a bank should take into account the incompleteness of the calculation dataset…."

B.6 Inflation-adjustments to data

(Excerpt from the Supervisory Guidance p. 37, sec. 191) –

"191. A bank should consider applying appropriate adjustment rates on data when inflation or deflation effects are material. For example, when the observation period for a specific ORC is extensive (eg 15-20 years) due to the infrequent occurrence of loss events, the adjustments on the oldest loss amounts due to discount effects could be relevant."

AMAG Response Commentary:

AMAG agrees that materiality should be a guiding factor in determining whether historical data adjustments should be made.

AMAG Requested Revision:

AMAG suggests that the word "should" in the first sentence of paragraph 191 be replaced with "may".

B.7 Combining the Elements

(Excerpts from the Supervisory Guidance pp. 50-51, par. 260 to 263) –

"Combining the elements

"260. There are various ways that an AMA model can be constructed to effectively incorporate the four data elements. A bank should carefully consider how the data elements are combined and used to ensure that the

bank's operational risk capital charge is commensurate with its level of risk exposure. A bank should provide a clearly articulated rationale for their modelling choices and assumptions and conduct sufficient research and analysis to support their decisions. The approach adopted should also encourage ownership of the outcomes and be readily understood by the business. It is highly desirable that there is no disconnect between the measurement and the management of operational risk within the bank. The Committee recognises that operational risk modelling continues to evolve and encourages further investigation into the combination of the four data elements within AMA models.

"Mixing of outcomes from AMA sub-models

"261. The Range of Practice Paper recognises that "[t]here are numerous ways that the four data elements have been combined in AMA capital models and a bank should have a clear understanding of the influence of each of these elements in their capital model". In some cases it may not be possible to:

> **"(a) Perform separate calculations for each data element; or**
>
> **"(b) Precisely evaluate the effect of gradually introducing the different elements.**

"262. While in principle this may be a useful mathematical approach, certain approaches to modelling may not be amenable to this style of decomposition. However, <u>regardless of the modelling approach, a bank should have a clear understanding of how each of the four data elements influences the capital charge</u>. (emphasis added)

"263. A bank should avoid arbitrary decisions if they combine the results from different sub-models within an AMA model. For example, in a model where internal and external loss data are modelled separately and then combined, the blending of the output of the two models should be based on a logical and sound statistical methodology. There is no reason to expect that arbitrarily weighted partial capital requirement estimates would represent a bank's requisite capital requirements commensurate with its operational risk profile. <u>Any approach using weighted capital charge estimates needs to be defensible and supported, for example by thorough sensitivity analysis that considers the impact of different weighting schemes</u>."(emphasis added)

AMAG Response Commentary:

> AMAG agrees with the Supervisory Guidance Document's approach, whereby banks should conduct the necessary work to justify the appropriateness of how each of the input elements is combined in the AMA. One significant issue for AMAG, however, is any implication that an explicit weighting mechanism must exist in AMA for each of the input elements. In AMAG's view the creation of an explicit weighting process/mechanism within the AMA was not and should not have been intended. The introduction of an explicit weighting process would introduce unnecessary complexity and potential arbitrariness into the AMA process and impact the risk sensitivity of results. AMAG believes that the Document supports this position that weightings are implied and that an organization must be capable of measuring the impact of each of the input elements on the capital estimate.

AMAG Requested Revision:

> No specific wording changes requested.

B.8 Granularity

(Excerpt from the Supervisory Guidance p. 8, par. 33) –

"33. Due to the nature and diversity of operational risk across an institution, a bank should define its operational risk categories (ORC). A bank's risk measurement system and capital charge calculation is greatly influenced by the number of ORCs used within the model. There is currently a great variation both in the choice and the number of ORCs used by banks. It is the Committee's aim to ensure that banks use comparable standards when selecting ORCs for modelling operational risk."

AMAG Response Commentary:

> AMAG agrees that there should be general consistency on the level of granularity related to ORCs, and furthermore that the selection of ORCs should be defensible. AMAG cautions, however, that any efforts to prescribe more granular ORCs be supported by appropriate analysis.

AMAG Requested Revision:

> No specific wording changes requested.

B.9 Timing and Rapidly Recoverable Losses

(Excerpts from the Supervisory Guidance pp. 21-22, sec. 87(a) and 87(b) –

"87. The inclusion or exclusion of the following items depends on their nature and materiality.

"(a) Timing losses are defined as the negative economic impacts booked in an accounting period, due to operational risk events impacting the cash flows ("lower cash in/higher cash out") of previous accounting periods. Timing impacts typically relate to the occurrence of operational risk events that result in the temporary distortion of an institution's financial accounts (eg revenue overstatement, accounting errors and mark-to-market errors). While these events do not represent a true financial impact on the institution (net impact over time is zero), if the error continues across two or more accounting periods, it may represent a material misrepresentation of the institution's financial statements. However, material "timing losses" due to operational risk events that span two or more accounting periods should be included in the scope of operational risk loss when they give rise to legal risk.

"(b) Rapidly recovered loss events are operational risk events that lead to losses that are recovered over a short period. For instance, a large internal loss is rapidly recovered when a bank transfers money to a wrong party but recovers all or part of the loss soon thereafter. A bank may consider this to be a gross loss and a recovery. However, when the recovery is made rapidly, the bank may consider that only the loss net of the rapid recovery constitutes an actual loss. When the rapid recovery is full, the event is considered to be a 'near miss'"

AMAG Response Commentary:

AMAG welcomes supervisors' recognition that the inclusion or exclusion of timing losses and rapidly recoverable loss events depend on their nature and materiality. AMAG members are already consistent in assessing and applying lessons from these types of losses for risk management purposes. There is a wide range of practice among AMAG members, however, as to how these items are used for capital estimation, and AMAG believes that inclusion should remain at the discretion of individual institutions.

AMAG Requested Revision:

No specific wording changes requested.

Attachment C:

About the AMA Group

The Advanced Measurement Approaches Group (AMAG) was formed in 2005 by the Risk Management Association (RMA) at the suggestion of the U.S. AMA-BQT (formerly the Inter-Agency Working Group on Operational Risk). The RMA is a member-driven professional association whose purpose is to advance the use of sound risk management principles in the financial services industry.

The purpose of the AMAG is to share industry views on aspects of Advanced Measurement Approaches (AMA) implementation with the U.S. financial services federal regulatory agencies. The Group consists of senior operational risk management professionals working at financial service organizations throughout the United States. The AMAG is open to any financial institution regulated in the United States that is either mandated, opting in, or considering opting in to AMA. A senior officer responsible for operational risk management represents each member institution on the AMAG. Of the US financial service institutions that are currently viewed as mandatory or opt-in AMA institutions; seventeen were members of the AMAG at the time of this writing.

The members of AMAG are listed below. Their names are provided for identification purposes only. This letter and its attachments do not necessarily represent the views of RMA's institutional membership at large, or the views of the individual institutions whose staff have participated in the AMAG.

Bank of America / Merrill Lynch
BNY Mellon
Capital One Bank
Citizens Bank
Deutsche Bank
Goldman Sachs
HSBC
JP Morgan Chase
Keycorp
Morgan Stanley
Northern Trust
PNC
State Street
SunTrust
TD Bank Financial Group
Union Bank of California
Wells Fargo / Wachovia Bank

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