

June 2, 2016

Secretariat of the Basel Committee on Banking Supervision (BCBS)
Bank for International Settlements
CH-4002 Basel
Switzerland
baselcommittee@bis.org

Re: Standardized Measurement Approach for Operational Risk

Dear Basel Committee Members:

The American Bankers Association¹ appreciates the opportunity to provide comments on the Basel Committee's (Committee) consultation, "Standardized Measurement Approach for Operational Risk" (Proposal). The Committee's consultation reflects the view that the Advanced Measurement Approach's (AMA) complexity and limitations of comparability in modeling practices have exacerbated variability in risk-weighted assets and eroded confidence in risk-based measures of capital. The Proposal recommends a Standardized Measurement Approach (SMA) to replace the AMA and the three existing standardized methodologies to calculate a capital charge for operational risk. The SMA is intended to balance simplicity, comparability, and risk sensitivity by combining a financial statement-based measure of operational risk – the Business Indicator (BI) – with an individual firm's operational losses, known as the Loss Component (LC).

We support the replacement of the AMA with a simpler and standardized calculation of operational risk capital that, importantly, does not appreciably increase overall capital requirements. Nevertheless, we believe that specific areas of the SMA can be improved and urge the Committee to consider our proposed methodological revisions.

The Committee should consider the inclusion of insurance and hedges when calculating operational risk capital. The LC's approach of using an annual average of 10 years of historical loss data is a suboptimal proxy for a bank's current operational risk controls. Risk scenario modeling and business environment and internal control factors (which were part of the AMA) are excluded, which may therefore distort incentives for risk management. The LC's backward-looking nature can be to some extent mitigated by permitting the removal of discontinued business activities from the 10-year observation period. We urge the Committee also to apply the previously used *de minimis* gross threshold of loss events of €20,000 and remove "timing losses" from the LC data set.

The proposed BI Net Interest Margin cap should be applied by discrete business line. We also urge the Committee to consider applicable exchange rates and permit the use of U.S. Generally

¹ The American Bankers Association is the voice of the nation's \$16 trillion banking industry, which is composed of small, regional and large banks that together employ more than 2 million people, safeguard \$12 trillion in deposits and extend more than \$8 trillion in loans.

Accepted Accounting Principles as they relate to SMA implementation. Finally, we ask the Committee to disclose its methodology for calibrating the SMA and provide clarification regarding potential future recalibrations.

Below we provide more specific feedback on areas where we believe the SMA can be improved.

Insurance and Hedges Should Be Included When Calculating Operational Risk Capital

The Proposal states that “[b]anks must not use losses net of insurance recoveries as an input for the SMA loss data set.” Hedges and insurance are key components of operational risk management and should be included ex-post when calculating an operational risk capital charge. That is, we believe insurance and hedges should affect the overall operational risk capital to be held and agree with their not being a factor in calculating historical loss events via the LC.

The LC Should Exclude Discontinued Business Activities

The Proposal does not provide a mechanism to exclude losses attributable to discontinued business activities from the LC. Losses from sold business activities - as defined by public securities filings indicating such sales - should be removed from the LC after three years, given that the impact of those activities would be excluded from the BI, which is based on an average of three years. Retaining, in the LC data set, historical losses for discontinued business activities would inaccurately reflect the current operational risk environment of a bank by overstating the entity’s operational risk, and may also result in the double counting of operational risk capital in the LC of both the acquiring and divesting bank’s SMA calculations.

“Timing Losses” Should Be Excluded from the LC Data Set

The Proposal states that material “timing losses”² should be included in the LC data set. As proposed, the framework already incorporates, via the BI and LC, fines and penalties for losses related to timing differences. Further, the inclusion of timing losses as a loss event for purposes of calculating loss exposure represents an unjustifiable scope creep from the current AMA. Moreover, the proposed instructions are unclear and subject to differences in interpretation regarding the classification and reporting of “timing losses”; the definitions of a *material* “timing loss” and “more than one financial accounting period” are likewise subject to interpretation.

“Timing losses” should be excluded from the scope of loss exposure on the basis that they are different in nature to other operational losses, principally because they have a net impact over time equating to zero. We recommend that “timing losses” be excluded from the LC data set.

² Timing impacts typically relate to the occurrence of operational risk events that result in the temporary distortion of an institution’s financial accounts (e.g., 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 more than one financial account period, it may represent a material misrepresentation of the institution’s financial statements.

Maintain Previous *de Minimis* Threshold of €20,000

The previous *de minimis* gross threshold of loss events was €20,000, and we believe that this threshold should be maintained when calculating the LC, as opposed to the €10,000 proposed in the consultative document. In addition to ensuring consistency with existing measurement approaches, capturing losses of less than €20,000 would be unnecessarily burdensome (with no explained benefits) as existing systems and processes are designed for the €20,000 threshold. The Proposal currently states that the *de minimis* gross loss threshold of €20,000 is acceptable for banks that first move to the SMA, but it does not explain the reduction from €20,000 to €10,000 for all other banks. We urge the Committee to consider applying the €20,000 *de minimis* gross threshold to all banks subject to the SMA.

Proposed Net Interest Margin (NIM) Cap Should Be Applied by Discrete Business Line

We appreciate the Basel Committee's inclusion in the Proposal of a NIM cap of 3.5% of interest earning assets at the total bank level to attempt to normalize the BI for high NIM business models. We recommend a change to the proposed approach to account for the fact that high NIM business models exist within institutions that have a range of business models but have an overall NIM under 3.5%. As a result, the same business can have very different capital requirements depending on the business mix of the overall institution. For example, suppose Institution A has a 3% overall NIM and Institution B has a 4% NIM and that each have a business with 10% NIM that they are attempting to grow. For the same 10% NIM new business, Institution A can see an incremental capital impact that is almost 3 times as much as Institution B. The inclusion of a NIM cap at the bank level penalizes high NIM businesses at banks with a NIM under 3.5%. These high NIM businesses are typically covering higher credit costs, and the Proposal may therefore operate to reduce credit availability.

The issue can be resolved if the cap is applied by discrete business lines rather than at the total bank level.

Permit the Use of U.S. Generally Accepted Accounting Principles for BI Calculations

Annex 1 identifies accounting items relevant to BI calculations. We urge the Committee to permit the use of U.S. Generally Accepted Accounting Principles.

Clarify Exchange Rate

The Proposal utilizes Euros as the denominating currency. We urge the Committee to clarify the applicable exchange rate for converting to local jurisdiction currencies other than the Euro and how this exchange rate will be reviewed or adjusted for future SMA calculations.

How Frequently Will the SMA Framework Be Recalibrated and Will SMA Calibration Be Made Public?

The Proposal states that the “results of the recent Quantitative Impact Study (QIS) related to the proposals will be a key input to the final design and calibration of the operational risk framework.” We urge the Committee to provide clarification as to whether and through what

mechanism future revisions to the SMA may be expected based on any future QIS. (One example of recalibration might be adjusting the NIM cap to reflect a different interest rate environment.) We also ask that the Committee disclose its methodology for calibrating the SMA in both the final SMA for which a QIS was recently completed and future recalibrations based on any future QIS.

What Is the Length of the Transition/Implementation Period and Will There Be an Opportunity to Comment on the Updated Calibration?

The Proposal states that the Committee intends to “publish the final standard with an appropriate timeframe and provide sufficient time for implementation.” Once the SMA framework has been recalibrated based on the QIS results, we ask for the opportunity to comment again - not on the concept of the SMA - but on the revised calibration. We also urge the Committee, when considering the timeframe for implementation, to permit early adoption for those banks that are capable of moving forward quickly with the new SMA.

How Frequently Would Capital Calculations Be Required?

We ask the Committee to clarify the frequency with which Operational Risk Capital calculations would be required. Consistent with the goals of reducing variability in risk-weighted asset calculations, we urge the Committee to consider an annual calculation requirement.

Conclusion

We thank you for considering our comments. If the Committee would like additional information regarding these comments, please contact Barry Mills at (202) 663-5311.

Sincerely,

A handwritten signature in cursive script that reads "Barry Mills". The signature is written in dark ink and is positioned below the word "Sincerely,".

Barry Mills
Senior Regulatory Advisor
Office of Regulatory Policy