



American Express Company
200 Vesey Street
New York, NY 10285

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Via Electronic Delivery

Secretariat of the Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel, Switzerland

Re: Operational Risk – Revisions to the Standardised Approach

Ladies and Gentlemen:

American Express Company (“American Express”) appreciates the opportunity to provide comments to the Basel Committee on Banking Supervision (the “BCBS” or “Committee”) on its second consultative document (the “Consultation” or “SMA”) proposing revisions to the standardized approach to the calculation for operational risk capital requirements for banking organizations.¹ The Committee issued an initial consultative document on October 6, 2014 (“Initial Consultation”)² to which American Express submitted comments on January 5, 2015.³

American Express appreciates the BCBS’ efforts to minimize the potentially disproportionate capital outcomes generated by the Initial Consultation for “banks with high fee revenues and expenses.”⁴ However, American Express also believes that the objectives of the Consultation may be furthered by incorporating the additional enhancements described herein, including:

¹ BCBS, Consultative Document: Standardized Measurement Approach for operational risk (Mar. 2016), available at <http://www.bis.org/bcbs/publ/d355.pdf>.

² BCBS, Consultative Document: Operational risk – Revisions to the simpler approaches (Oct. 2014), available at <http://www.bis.org/publ/bcbs291.pdf>.

³ American Express submitted comments to the BCBS regarding its consultative document “Operational risk – Revisions to the simpler approaches.” available at <http://www.bis.org/publ/bcbs291/americanexpress.pdf>.

⁴ Consultation at 4.

1. Replace the Business Indicator's ("BI") profit and loss ("P&L") inputs with an alternative measure;
2. Incorporate several adjustments to the BI component measures, if the Committee elects to maintain the proposed BI inputs;
3. Adjust the Loss Component ("LC") to reflect covered banks' operational risk management environment;
4. Ensure appropriate conversion rates for jurisdictions using a currency other than the Euro and regularly recalibrate BI and LC ranges and thresholds; and
5. Review the potential capital impact of the Consultation on a stand-alone basis and in combination with other anticipated revisions to the standardised approach.

I. Context

The proposed SMA framework would determine operational risk capital outcomes, in large part, based on certain line items from each bank's P&L. By using a bank's P&L as the foundation for the BI, this framework generates disproportionately high capital outcomes for high revenue and fee-intensive business models, relative to the operational risk presented by such business activities. The Initial Consultation acknowledged this potential, describing the "disproportionately high capital impact"⁵ for banks with business models that generate relatively high fee income. The recently-proposed Consultation includes adjustments aimed to limit this impact – however, maintaining the P&L as the foundation for the BI would continue to lead to inappropriate capital outcomes for certain business models, including those generating relatively high profit levels. According to regularly reported Federal Deposit Insurance Corporation ("FDIC") releases, credit card businesses on average generate significantly higher revenues to assets, expenses to assets, return on assets and return on equity, compared to all other types of banking models in the U.S.⁶ Importantly, there is no clear association between those high returns and higher operational risk. Therefore, credit card businesses, which typically generate more revenue (especially fee income) relative to providers of

⁵ Initial Consultation at 3.

⁶ See FDIC "Quarterly Banking Profile" (Mar. 2016) *available at*: <https://fdic.gov/bank/analytical/qbp/2016mar/qbp.pdf> and "Statistics at a Glance" (Mar. 2016) *available at*: <https://www.fdic.gov/bank/statistical/stats/2016mar/industry.pdf>.

other major banking products, would be subject to disproportionately high capital outcomes under the Consultation. This is particularly true for American Express.

American Express' principal products and services include charge and credit card payment products and services for consumers and businesses around the world. As a part of its "monoline" business, American Express operates a payments network that processes and settles proprietary and non-proprietary card transactions. This end-to-end process generates significant fee income, which constituted 82% of the company's total revenue in 2015. The two primary sources of fee income are fees charged to merchants when card members use our cards to make purchases and those paid by customers for annual card memberships.⁷ Our business model focuses on generating revenues primarily by driving spending on our cards - thereby earning fees from card-accepting merchants - and only secondarily by interest income. In fact, a large segment of our card members are "transactors," who pay either in full or a large portion of the balance each month and therefore do not create interest income to the same degree as "revolvers," who routinely carry a balance over time and accrue interest charges. Other issuers are more concentrated in lending to "revolvers" and thereby generate a larger portion of interest income, compared with fees. Furthermore, customer spending on our cards is higher on average, on a per-card basis, which generates higher revenues overall, compared with other card issuing banks. In turn, these higher revenues translate into disproportionately high capital outcomes relative to the operational risk presented by our business activities.

We recognize and appreciate the efforts of the Committee to mitigate the "overcapitalization of banks with high fee revenue and expenses" in the Consultation. We believe that these efforts represent an improvement over the originally-proposed BI.

⁷ American Express' products and services generate the following types of revenue:

- Discount revenue, our largest revenue source, which represents fees generally charged to merchants when Card Members use their cards to purchase goods and services at merchants on our network;
 - Net card fees, which represent revenue earned for annual Card Memberships;
 - Travel commissions and fees, which are earned by charging a transaction or management fee to both customers and suppliers for travel-related transactions;
 - Other commissions and fees, which are earned on foreign exchange conversions, card-related fees and assessments and other service fees;
 - Other revenue, revenues arising from contracts with partners of our Global Network Services business (including commissions and signing fees), insurance premiums earned from Card Member travel and other insurance programs, prepaid card-related revenues, revenues related to our Global Business Travel joint venture transition services agreement, earnings from equity method investments and other miscellaneous revenue and fees; and
 - Interest on loans, which principally represents interest income earned on outstanding balances.
- Details are available in American Express' Consolidated Results of Operations, included in its Annual Report on Form 10-K (<http://ir.americanexpress.com>)

Unfortunately, it appears that the Consultation would nonetheless result in increased capital requirements for the banking industry overall and particularly for credit card issuers with fee-based business models like American Express. In fact, American Express estimates that the proposal would generate capital outcomes significantly in excess of its current Advanced Measurement Approach (“AMA”) requirements. Therefore, additional enhancements are necessary in order to meet the BCBS’ objectives to “avoid penalizing certain business models,” “not significantly increase overall capital requirements” and “ensure that the framework produces capital requirements that are prudent and stable, while retaining risk-sensitivity.”⁸

II. BI Considerations

The structure of the proposed SMA reflects the BCBS’ apparent view that operational loss exposure increases more than proportionally with a firm’s size.⁹ Assuming that is the case, it nonetheless remains unclear why P&L metrics are appropriate measures for size and, ultimately, operational risk. Further, using P&L measures could generate counterintuitive capital outcomes, increase cyclicity, reduce consistency among banks, and mis-align capital with drivers of operational risk.

Under the proposed framework, firms with similar business models would appear subject to asymmetric capital outcomes based on profitability, rather than operational risk profile. For example, a bank with a credit card business that is more profitable and has significantly fewer drivers of operational risk (e.g. lower transaction volume, fraud, physical locations, business lines, etc.) relative to industry peers would actually be subject to *higher* operational risk capital requirements as a result of the profitable nature of its business (as reflected in the Services component of its BI).

Calibration based on the P&L may also result in lower capital requirements during times of economic stress, when profitability is impaired. We respectfully submit that an alternative construct creating more stable outcomes through economic cycles would be a more appropriate approach.

Variability would also be created between banks based on accounting practices, which vary across jurisdictions, and as applicable accounting rules change, capital outcomes would fluctuate, as well. Banks apply a variety of approaches to reporting

⁸ Consultation at 2 and 3.

⁹ See Consultation at 3; “Banks are divided into five buckets according to the size of their BI...[and] the marginal effect of the BI on the BI component is greater for the higher buckets than for the lower ones.” Id. at 6.

across the P&L, which creates significant challenges to achieving the Committee's goal of ensuring comparability of capital outcomes across banks. As an example, accounting treatment for rewards expense by credit card issuers varies widely and could result in significant differences in capital outcomes for credit card issuing banks, based on how each firm accounts for such expenses.

Finally, the framework is structured in a manner where operational risk capital outcomes are not aligned with the nature of the underlying risk. This is particularly true for credit card businesses where typical sources of operational risk losses, such as external fraud, do not appear to be conceptually correlated with the P&L metrics included in the BI. For American Express, these loss types represent over half of our total operational risk losses. American Express therefore urges the Committee to consider other potential indicators of operational risk such as the number of customers, transactions, product lines, geographies, employees, or other such measures that may better correlate to the generation of operational risk. Alternatively, if the Committee determines to use a measurement of size to estimate operational risk, it may consider leveraging its existing "G-SIB" assessment methodology which offers an established framework to measure size.¹⁰

The Consultation also recognizes that "in some cases, there could be significant differences in operational exposure between banks of similar BI values."¹¹ Given the potential for the BI to generate inappropriate outcomes relative to actual underlying risk, the Committee may also consider recalibrating the relative weights assigned to the BI and the bank-specific LC. Such an approach would both improve the framework's risk sensitivity and provide incentives for banks to maintain strong operational risk management.¹²

III. If BI Components Retained, Technical Adjustments to Services and Interest

If the Committee elects to maintain the proposed BI inputs, American Express offers several suggested enhancements to both the Services and Interest components. The changes to the Services component described herein would serve the BCBS' stated goal of preventing overcapitalization of banks with relatively high fee revenue and the

¹⁰ See BCBS "Global systemically important banks: updated assessment methodology and the higher loss absorbency requirement" (July 2013) available at: <http://www.bis.org/publ/bcbs255.pdf>.

¹¹ Consultation at 6.

¹² Consultation at 3.

below adjustments to the Interest component would avoid potential inconsistency between the Committee's existing capital and liquidity frameworks.

A. *Services*

As noted in Section I, American Express appreciates the adjustments made to the Services component in an effort to avoid inappropriate capital outcomes for banks with relatively high fee income concentrations. However, American Express believes that it would be appropriate to further refine this calculus, as described below.

American Express urges the Committee to adjust the Services component in order to calculate the BI based simply on net fee income, rather than the currently proposed construct which is based on the greater of total fees and total expenses.¹³ Such an adjustment is consistent with, and has precedent in, the other components of the proposal - including both the Interest and Financial component calculations. For these components, the Consultation employs a netting mechanism, in order to limit the potential capital impact to businesses with significant levels of activities classified in those segments. For the Service component, however, netting is used only to establish the minimum floor. American Express fully supports a consistent approach across BI components and therefore respectfully submits that the Services component should net expenses from fee income for the baseline measure. This would also obviate the need for the currently proposed minimum floor for the Fee component (which appears binding in the U.S. only on American Express, based on peer bank analysis), as the floor is based on net fee income. In conjunction with this adjustment, and in order to prevent overly punitive capital outcomes for banks with the "originate to distribute" business model, American Express also recommends the Committee to re-evaluate the exclusion of certain expense items from BI calculations, including administrative expenses, which are more significant for banks with this business model and therefore should be netted against service income.

Should the Committee elect to maintain the proposed framework, we alternatively request that the Committee review the threshold for limiting fees included in the BI and remove the proposed floor to the Fee component. The current proposal would limit to 10% those fees in excess of 50% of the unadjusted BI. American Express urges the Committee to consider whether development of firm-specific thresholds would generate more appropriate risk outcomes. For example, instead of the proposed standard threshold

¹³ More specifically, American Express believes the BCBS should replace usage of "Max (Fee Income; Fee Expense)" with " $|\text{Fee Income} - \text{Fee Expense}|$ ", and similarly, "Max (Other Operating Income; Other Operating Expense)" with " $|\text{Other Operating Income} - \text{Other Operating Expense}|$ ". The same change should also be applied to the calculation of Unadjusted BI.

of 50% of unadjusted BI, the Committee could consider using a bank's actual proportion of the Fee component within the unadjusted BI. More specifically, the Consultation could include $(1 - \text{actual proportion of Fee/uBI})$ to replace the current 50% threshold.¹⁴ Under this alternate construct, banks with a higher fee income concentration would receive a proportionally higher adjustment to avoid overcapitalization inherent in the proposed framework. In conjunction with this adjustment, American Express also encourages the Committee to remove the proposed floor, which unnecessarily penalizes high margin businesses without any clear nexus to operational risk. Contrary to the Committee's intention to avoid asymmetric impact on the "distribute only" and the "originate to distribute" business models,¹⁵ this construct would create punitive outcomes for the latter.

B. *Interest*

American Express also supports aligning certain line items from the Interest component of the BI with other BCBS frameworks such as the Liquidity Coverage Ratio ("LCR"). More specifically, the Consultation includes as interest-earning assets in the BI government bonds and similar assets that qualify as High Quality Liquid Assets ("HQLA") for LCR purposes. This results in a system that incents holding such instruments for liquidity purposes but penalizes from a capital perspective. In order to rationalize these frameworks, American Express therefore believes that instruments qualifying as HQLA, including funds held as reserves at central banks, should be excluded from the Interest component of the BI.

Additionally, American Express supports comments submitted to the BCBS by the American Bankers' Association ("ABA"), proposing to cap the Net Interest Margin by discrete business lines rather than at the total bank level.

IV. Loss Component

Several adjustments to the LC would improve the BCBS' goal to enhance the framework's risk sensitivity. Importantly, the Consultation's Internal Loss Multiplier ("ILM") does not recognize financial and other investment or other management actions to improve the business environment and internal control factors. American Express

¹⁴ Under this proposed approach, the Service component would be calculated alternatively as:
Service Component = $\text{Max}[\text{Other Operating Income, Other Operating Expenses}] + \text{Min}[\text{Max}(\text{Fee Income; Fee Expenses}), \mu * \text{unadjusted BI} + 0.1 * \{\text{Max}(\text{Fee Income, Fee Expenses}) - \mu * \text{unadjusted BI}\}]$,
where $\mu = 1 - \text{Max}(\text{Fee Income, Fee Expenses}) / \text{unadjusted BI}$.

¹⁵ Consultation at 3.

therefore supports adjustment to the LC to better reflect a bank's existing operational risk management environment rather than calibrate based solely on historical loss experience.

As noted above, the proposal would generate capital requirements significantly in excess of American Express' current AMA requirements due, in part, to the structure of the ILM. In general, American Express believes that the proposed LC includes inappropriately high loss multipliers and should be recalibrated. American Express also urges the Committee to differentiate between loss types in the LC. For example, fraud losses are the largest and most predictable source of operational risk losses for American Express and do not warrant impact to capital outcomes on par with less predictable loss events, such as legal losses. Therefore, American Express encourages the Committee to recalibrate the LC, appropriately.

We also support enhancing the LC by appropriately reflecting amounts that banks ultimately recover (e.g. fraud-related losses refunded to the bank and actual payouts from insurance policies), which reduce overall loss amounts. This, in turn, would provide a more accurate reflection of true loss experience. Finally, American Express also supports the ABA's proposal to exclude losses attributable to discontinued or divested business activities, which would overstate the current operational risk environment, along with "timing losses," which are already included in the BI and LC.

V. National Implementation and Recalibration

American Express fully supports the goal of the Consultation to "encourage a level playing field."¹⁶ In order to achieve this goal, American Express urges the BCBS and national regulators to ensure that capital requirements for credit card businesses are consistent both across and within jurisdictions.

To foster international consistency, American Express urges the Committee to clarify how exchange rates for converting from the Consultation's Euro-denominated calibration to local currencies (which significantly impact the overall capital outcomes under the framework) will be established. By way of comparison, the Committee instructs banks reporting G-SIB indicator data to use the exchange rates published on the BCBS' website, in order to ensure consistency across banks from various jurisdictions.¹⁷ Additionally, American Express believes it is important for the Committee and national

¹⁶ Consultation at 1.

¹⁷ BCBS "G-SIB assessment methodology – score calculation" (Nov. 2014) *available at*: <http://www.bis.org/bcbs/publ/d296.pdf>.

regulators to regularly review and, when appropriate, recalibrate both BI and LC ranges and thresholds.

In addition to consistent application between jurisdictions, the method of implementation by local regulators is of critical import. American Express urges the Committee and local regulators to implement such changes in a manner designed to avoid creating additional competitive imbalances between banks.

VI. Data Collection

The Consultation noted that “the Committee will carefully evaluate the efficacy of the logarithmic function and may consider alternative approaches to ensure a stable and risk sensitive framework.”¹⁸ American Express fully supports the consideration of alternative approaches (including those described above) and believes that this QIS should collect and analyze data from an appropriately diverse group of financial institutions, including fee-intensive banking organizations, and that in all events, the revisions should not be finalized until QIS results have been released to the public for review and comment. Such an approach will increase the probability that operational risk capital requirements are appropriately calibrated and tailored to the diversity of banking organizations to which they apply.

VII. Cumulative Impact with Other Recent BCBS Proposals

American Express also urges the BCBS to consider the impact of the Consultation in combination with other recently proposed revisions to the standardised approach. American Express has concerns that the cumulative impact to regulatory capital charges for banks that have significant credit card lending portfolios and operate a credit card payment network would be unfairly punitive and incongruent with underlying risk. Although American Express’ comments in this letter focus exclusively on the Consultation, we strongly urge the BCBS to consider the cumulative impact of all proposed changes in any QIS exercise and in the finalization of this Consultation, as well as others.

VIII. Conclusion

American Express appreciates the BCBS’ efforts to minimize the potentially disproportionate capital outcomes generated by the Initial Consultation for “banks with high fee revenues and expenses.” Importantly, however, American Express also believes

¹⁸ Consultation at 7.

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that the objectives of the Consultation would only be accomplished by incorporating the additional enhancements discussed in this letter.

Thank you for considering our comment letter. We appreciate the opportunity to share our views with the BCBS. If we may be of further assistance, please contact Richard Petrino at Richard.Petrino@aexp.com and +1-212-640-5516.

Sincerely,

A handwritten signature in dark ink, appearing to read "Jeff Campbell", is positioned above the printed name.

Jeffrey Campbell
Executive Vice President &
Chief Financial Officer

cc: Paul Fabara
Ashwini Gupta
Anderson Lee
Vernon Marshall
Juliana O'Reilly
Richard Petrino
Jonathan Polk
Gabrielle Vitale
David Yowan
American Express Company