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January 6, 2015

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 simpler approaches

Ladies and Gentlemen:

American Express Company ("American Express") appreciates the opportunity to provide comments to the Basel Committee on Banking Supervision (the "BCBS") on its consultative document (the "Consultation") that proposes revisions to existing approaches to the calculation of operational risk capital requirements for banking organizations.[1] In this letter, we focus our comments on the potential effect of the Consultation on banking organizations that are highly specialized in fee-based businesses and conduct significant fee-based activities ("fee-intensive banking organizations").[2] As a fee-intensive banking organization, American Express agrees with the proposition that the Consultation could have a "disproportionately high capital impact"[3] on fee intensive banking organizations and require significantly higher regulatory capital levels that are not appropriate for the actual level of operational risk for those types of organizations. There are several recommendations that we propose in this letter which the BCBS should consider implementing in order to achieve an outcome that accomplishes the BCBS's goal of "correctly estimating the operational risk capital requirement of a wide spectrum of banks."[4]

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

[2] Based on current understanding of how the Revised Approach may be applied.

[3] Consultation at 3.

[4] Id. at 1.

American Express believes there are a number of potential solutions to address the concerns identified in this letter, which would result in more tailored and appropriate operational risk capital requirements for fee-intensive banking organizations. As described more fully below, these include:

(A) Modifications to the calibration of regulatory coefficients by (i) replacing the proposed coefficients with alternatives that take into account fee-intensive banking organizations and the diversity of bank business models, (ii) specifically modifying the calibration of the coefficients for fee-intensive banking organizations, or (iii) distinguishing a banking organization's net interest margin-based Business Indicator ("BI") component from its fee-based BI component and applying two different sets of coefficients;

(B) Modifications to the Services component of the BI by (i) netting expenses closely tied to fee income, (ii) developing boundary ranges for fee income, and (iii) recognizing variation in operational risk-sensitivity between types of fee income generating activities;

(C) Modifying the applicability of the Consultation; and

(D) Improvements to data collection.

I. Background

American Express is a global services company whose principal products and services include charge and credit payment card products and services for consumers and businesses around the world. As a part of its business, American Express operates a global payments network that processes and settles proprietary and non-proprietary card transactions. These fee-based activities generate a significant portion of American Express' total revenue.[5] However, the revisions set forth in the Consultation could result

[5] 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, which represents revenues arising from contracts with partners of our Global Network Services business (including royalties and signing fees), insurance premiums earned from Card Member travel and other insurance programs, Travelers Cheques and prepaid card-related revenues and other miscellaneous revenue and fees; and
- Interest on loans, which principally represents interest income earned on outstanding balances.

in a "disproportionately high capital impact"[6] for a fee-intensive banking organization such as American Express.

The Consultation proposes to replace the existing Simpler Approaches to the calculation of operational risk capital requirements with a revised Standardized Approach (the "Revised Approach") that would include a new proxy indicator for operational risk and framework for applying regulatory coefficients. Specifically, the Revised Approach would replace the existing "Gross Income" proxy with a Business Indicator "comprise[d of] the three macro-components of a bank's income statement" which, according to the BCBS, better "capture[s] a bank's exposure to the operational risk inherent in a bank's mix of business activities."[7] In addition, the Revised Approach would replace existing "regulatory betas"[8] based on business lines with a uniform, progressive scale of coefficients based on the dollar amount of the BI.[9]

The BCBS explains that the Revised Approach is "designed to capture the operational risk profile of [] universal bank[s]" (*i.e.*, banking organizations engaged in a variety of banking and other financial activities). For such banks, the "dominant component" of the BI is usually interest.[10] Conversely, American Express, a fee-intensive banking organization, believes it would attribute approximately 90 percent of its BI to the services component if the Revised Approach were applied to it.[11] The BCBS further acknowledges that the Revised Approach "does not lend itself to accurate application in the case of banks engaged predominately in fee-based activities."[12] As such, the Consultation would have a "disproportionately high impact" on a "small

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Details are available in American Express' Consolidated Results of Operations, included in its Annual Report on Form 10-K (http://ir.americanexpress.com)

6 Consultation at 3.

7 Id. at 2.

8 Id. at 7.

9 Id. at 11.

10 Id. at 15.

11 Based on current understanding of how the Revised Approach may be applied.

12 Id. at 16.

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number of banks . . . highly specialized in fee businesses."[13] In recognition of these issues, Question 8 of the Consultation specifically requests comment on the treatment of fee specialized businesses; this letter responds to that request.

II. Impact on Banking Organizations Engaged in Fee-Based Activities

American Express believes that the disproportionate impact the Revised Approach would have on fee-intensive banking organizations must be remedied. By adding service expenses to the proxy indicator and calibrating the coefficients based on a universal bank model with limited fee income, the Revised Approach would lead to inflated operational risk capital requirements unjustified and unsupported by American Express' experience with operational losses; this could potentially lead to significant negative impacts on fee-intensive banking organizations. We believe that these impacts are not intended, based on the stated rationale to improve calibration of the calculation of operational risk capital requirements.

The Consultation states that "a single non-model-based approach…addresses the Committee's objectives of promoting simple and comparable approaches while still maintaining risk sensitivity."[14] The Consultation also states that "a small number of banks which are highly specialized in fee businesses have been identified as facing a disproportionately high capital impact under the BI."[15] These revisions would force fee-intensive banking organizations to bear the costs of this simplicity, and the BCBS should revise its approach to avoid penalizing these banking organizations. We submit that it would be arbitrary and unfair to penalize fee-based activities, which, as the BCBS itself acknowledges, do not appear to present a materially higher operational risk profile than other banking and financial services.[16] Indeed, American Express is concerned that an operational risk capital requirement that penalizes these activities could, in effect, incentivize the industry to engage in more risky activities.

Below, we offer specific suggestions to revise the Consultation to avoid unintended and disproportionate impacts on fee-intensive banking organizations such as American Express.

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13 Ibid.

14 Consultation at 2.

15 Id. at 3.

16 Ibid. ("The analysis of the current TSA using the OpCaR model revealed that the regulatory business lines do not differ statistically in terms of riskiness when the riskiness is measured by coefficients applied to the proxy indicator apportioned between the business lines").

III. Proposed Revisions to Consultation

In order to ensure that the Revised Approaches do not arbitrarily or inappropriately penalize fee-intensive banking organizations, American Express respectfully requests that the BCBS consider the following steps.

A. Modify Calibration of Coefficients

American Express believes that applying the proposed standard coefficient, which is based solely on size, to the BI penalizes businesses with lower inherent operational risks while providing relative relief to businesses with higher inherent risks. As the BCBS acknowledges, the proposed calibration of the coefficients is based on a "universal bank" model that assumes that fee-based activities comprise a less than predominant proportion of a banking organization's overall activities. Therefore, the Revised Approach is designed for banks that have multiple business lines across the spectrum of BI components and thus subject to a range of different inherent operational risks. This is, however, in conflict with one of the stated principles considered when formulating the Revised Approach which was "to calibrate according to the operational risk profile of a large number of banks of different size and business models."[17] A more risk-sensitive calculation would also be consistent with efforts by individual jurisdictions to better tailor capital requirements to banking organizations of different sizes and business models.

The proposed regulatory coefficients should be revised in order to limit the inappropriate overstatement of operational risk for fee-intensive banking organizations. Specifically, American Express believes that the BCBS should (i) replace the coefficients with alternatives that take into account fee-intensive banking organizations and the diversity of bank business models, (ii) specifically modify the calibration of the coefficients for fee-intensive banking organizations or (iii) distinguish a banking organization's Interest and Financial BI components from its Services, or fee-based, BI component and apply up to three different sets of coefficients to appropriately capture differences in the risks of activities in these categories.

B. Modify Calculation of Services Component

1. Net Expenses Closely Tied to Income

The Revised Approach includes fee income and expenses on a gross rather than net basis. Although the Revised Approach assumes the same inherent level of operational risk among the three components of the BI, the Services component is

[17] Id. at 7.

implicitly assigned a higher weight than the other components given that income and expenses are summed up instead of netted. The BCBS proposal does not net income and expenses in the Services component of the BI. This has the effect, therefore, of inadvertently putting at a disadvantage activities falling under the Services component, an effect that is compounded for fee-intensive banking organizations which have the vast majority of their activities included in this category. The BI calculation would be significantly higher for fee-intensive banking organizations relative to other firms that have different business models.

In support of not permitting netting in the calculation of the Services component of the BI, the BCBS states that "[u]nlike in the case of lending business, where funding and investing are closely tied to each other, there is no comparable relationship between services offered and services used."[18] American Express disagrees with this assertion, as significant portions of fee-intensive banking organizations fee revenues and expenses may be closely tied to one another, as well. As an example, American Express' business model focuses on generating revenues by incentivizing Card Members to make purchases using their American Express charge and credit cards. American Express charges fees to merchants when Card Members use their cards to purchase goods and services. With each purchase that generates such fee income from merchants, Card Members earn rewards furnished by American Express, which is an expense that is closely related to the income generated from these business lines. The BCBS should take into consideration business models and activities where expenses are closely tied to income and modify the Services component to provide for appropriate netting of fee income and expenses. This would mitigate potentially punitive treatment for fee-intensive banking organizations, relative to other types of financial institutions.

2. Develop Boundary Ranges for Fee Income

The Consultation contemplates using a "boundary range" for banks with high net interest margin because, as the BCBS acknowledges, the framework could otherwise result in an inappropriately high calculation of operational risk.[19] Given the existence of fee-intensive banking organizations, the BCBS should include a boundary range for fee income, to ensure that the BI does not result in prevent an inappropriately high capital charge for these types of firms, similar to those with a high net interest margin. Under this approach, the Services component included in the BI would be capped and normalized downwards to better reflect operational risks of fee-intensive banking organizations.

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[18] Id. at 9.

[19] Id. at 3.

3. *Recognize Variation in Risk Sensitivity Between Types of Fees Within Services Component*

The Consultation states that two primary improvements associated with the Revised Approach are (i) reducing the weight of components associated with activities traditionally regarded as less exposed to operational risk and (ii) increasing the weight of components associated with activities more closely related to operational risk.[20] American Express believes that an important precondition for these objectives is accurate calibration associated with different types of fee income and expenses, based on their respective operational risk profiles. To this end, although the Consultation increases the relative weight of components associated with activities more closely related to operational risk, including "commissions from services payments, fees received from securitisation of loans and origination and negotiation of asset-backed securities, penalties from mis-selling and inadequate market practice,"[21] "many of which… were at the core of the financial crisis,"[22] the Consultation does not appear to appropriately distinguish low-risk, traditional credit card transactions from other fee-generating activities. For example, American Express generates a large portion of its revenues and related expenses from fees charged to merchants when Card Members use their cards to purchase goods and services (as discussed above). These fees present a fundamentally lower operational risk profile than those specifically referenced in the Consultation. To address this issue and achieve the stated objective of rationalizing component weightings, the Revised Approach should differentiate between types of fee-based activities, recognizing a distinction between fees associated with low-risk, traditional credit card activities and fees associated with activities that carry higher inherent operational risks.

C. Modify the Applicability of the Consultation

As the BCBS notes, the Consultation methodology is designed explicitly to capture the operational risk profile of universal banks. Question 2 in the Consultation requests comment on whether this methodology strikes an appropriate balance across the BCBS's objectives of simplicity, comparability and risk sensitivity. As a result of the disproportionate impact on fee-intensive banking organizations, American Express believes that this standard has not been met. Therefore, American Express believes that the BCBS should consider limiting the scope of the Consultation to universal banks and

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[20] Consultation at 10.

[21] Ibid.

[22] Ibid.

separately re-calibrate existing coefficients for fee-intensive banking organizations, as discussed in this letter.[23]

D. Improve Data Collection

The 2008 Loss Data Collection Exercise, 2010 Quantitative Impact Study ("QIS") and other BCBS operational risk data collections do not appear to encompass a diverse range of financial institutions. The BCBS appears to recognize this shortcoming and is currently conducting an additional QIS to validate the Revised Approach.[24]

American Express 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 Revised Approaches should not be finalized until QIS results have been exposed to the public for review and comment. Incorporating QIS results into the Revised Approaches will increase the probability that operational risk capital requirements are appropriately calibrated and tailored to the diversity of banking organizations to which they apply. [25]

IV. Conclusion

In sum, American Express believes that the Consultation's approach towards fee-intensive banking organizations would likely result in arbitrary, disproportionate and inappropriate increases in operational risk capital requirements for these banking organizations. The BCBS should revisit or otherwise revise the Consultation to remedy this shortcoming by (1) modifying the calibration of coefficients by replacing the proposed coefficients with alternatives that take into account fee-intensive banking organizations and the diversity of bank business models, specifically modifying the calibration of the coefficients for fee-intensive banking organizations or distinguishing a banking organization's net interest margin-based BI from its fee-based BI and applying

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23 This approach would permit the BCBS to revise the Simpler Approaches in a manner appropriate for universal banks, while still avoiding disproportionate and inappropriate negative impacts on fee-intensive banking organizations.

24 Id. at 1.

24 Id. at 1.

25 Through an industry group, American Express participated in a benchmarking data collection survey to quantify the impact of the Revised Approach. Preliminary results indicate that the required capital charge for fee-intensive banking organizations under the Revised Approach could be significantly more than the mean bank participating in the study. We offer to further discuss the final results with the BCBS, upon request.

two different sets of coefficients, and (2) modifying the calculation of certain components of the BI to net certain expenses, developing boundary ranges for fee income, and recognizing variation in operational risk-sensitivity between types of fee generating activities. In the alternative, the BCBS could limit the scope of the Consultation to universal banks, and develop a more appropriately calibrated framework for fee-intensive banking organizations. In all events, American Express believes the BCBS should refrain from finalizing the Revised Approaches until it has completed its latest operational risk QIS and exposed the results to public notice and comment.

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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 us at Vernon Marshall at Vernon.Marshall@aexp.com and +44-1273-211182 or Richard Petrino at Richard.Petrino@aexp.com and +1-212-640-5516.

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