

June 1, 2016

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

RMA / AMAG Comment Letter on SMA

Ladies and Gentlemen:

This comment letter is submitted by the Advanced Measurement Approaches Group (“AMAG” or the “Group”) of The Risk Management Association (“RMA” or the “Association”) in response to the Basel Committee on Banking Supervision (“BCBS” or “the Committee”) Consultative Document entitled “Standardised Measurement Approach (“SMA”) for operational risk” dated March 2016.

Many, but not all, of the members of AMAG favor a simpler approach to estimating operational risk capital requirements. Please note that in one of AMAG’s recent surveys regarding the SMA, fifty-eight percent (58%) of the members indicated that they would be in favor of a more simplified measurement approach, *in concept*. These AMAG members, and possibly more, might be in favor of SMA if its calibration and certain other aspects were to be improved. Reaction to the specific SMA proposal as currently constituted, however, is only mixed at this time.

Based upon AMAG members’ pro forma SMA calculations, and wide variances from current U.S. regulator-approved AMA capital levels, AMAG is certainly supportive of the BCBS plan to recalibrate its SMA formula, as described herein, with a view toward better alignment to current approved levels.

Background – RMA and AMAG

The Risk Management Association (“RMA”) is a 501(c)(6) not for-profit, member-driven professional association whose sole purpose is to advance the use of sound risk management principles in the financial services industry. RMA helps its members use sound risk management principles to improve institutional performance and financial stability and enhance the risk competency of individuals through information, education, peer-sharing and networking. RMA has 2,600 institutional members that include banks of all sizes as well as nonbank financial institutions. They are represented in the Association by more than 18,000 risk management professionals who are chapter members in financial centers throughout North America, Europe, and Asia/Pacific.

The AMAG was formed by RMA in 2005 at the suggestion of the U.S. AMA-BQT (formerly the Inter-Agency Working Group on Operational Risk). The purpose of the AMAG is to share industry views on aspects and implementation of Advanced Measurement Approaches (“AMA”) and operational risk aspects of the Comprehensive Capital Assessment and Review (“CCAR”), and Dodd-Frank Act Stress Test (“DFAST”) exercises with the U.S. financial services federal regulatory agencies. The Group consists of 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, or is required to conduct CCAR and/or DFAST exercises. A senior officer responsible for operational risk management serves as the primary representative of each AMAG member institution. Of the U.S. financial service institutions that are currently viewed as mandatory or opt-in AMA institutions or CCAR / DFAST institutions, twenty-six (26) are members of the AMAG at the time of this writing.

The members of AMAG are listed on Exhibit A attached. They are provided for identification purposes only. This letter does 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.

Summary - Requests for SMA Revision

A majority of AMAG members might be in favor of SMA if its calibration and certain other aspects were to be improved. Reaction to the specific SMA proposal as currently constituted is only mixed at this time.

This section summarizes a number of AMAG priority observations and specific requests for the Committee to consider in testing and otherwise improving the calibration of results under SMA. Each is supported more fully in the text of this letter.

1. **Re-calibration and Subsequent Comment Period** -- It is difficult, if not nearly impossible, for the industry to diagnose the issues causing the large variances seen in the AMAG members' pro forma calculations (*See* section on Pro Forma Calculations, below), without having the underlying data and other factors that the Committee is considering. The AMAG, therefore, supports the Committee's efforts to re-visit its SMA calibrations, in view of more complete loss data now available from the most recent QIS survey (2016), among other considerations. The AMAG trusts that this exercise will address the extreme variances that the members of the AMAG are observing between their pro forma SMA calculations and their current regulatory-approved AMA capital levels. Once the re-calibration is complete, the AMAG respectfully requests at least a 30-day in which to review the SMA calibrations and provide additional commentary.
2. **Revisions to the Loss Component ("LC")** – The members of the AMAG generally favor including a loss component in SMA. The Group requests several changes to the proposal, however, as follows.
 - a) Financial statement recognition of large losses -- As a means of introducing consistency, not the least of which will be greater stability of capital over time, losses should be applied on an "impact basis" in the formula as they develop over time and are realized on a bank's financial statements (i.e., an initial reserve recognition, if applicable, with subsequent adjustments as they develop).
 - b) Loss threshold – The Committee should consider setting a higher threshold than €10,000 in order to provide better data quality and comparability, preferably an amount of €20,000, which is more consistent with industry practices.
 - c) Loss data requirements should not be broader, or markedly different, than those under AMA. As one important example, the AMAG does not support including timing losses in the Loss Component. Elsewhere, a number of data requirements are needed, as outlined in our Clarifications / Guidance paragraph, below.
 - d) The Loss Component breakpoints are an issue, but AMAG members are divided on the question of whether to leave them intact, or eliminate them and recalibrate the formula to apply the Loss Component to the 10-year average of total losses, along with a single loss multiplier. Members of the Group would, however, generally favor a feature that would better align the size of losses to the size of institutions, thereby, conceivably achieving a better alignment to current AMA capital levels.

- e) Discontinued businesses – The AMAG respectfully requests that the Committee allow banks to apply to their supervisors for a ‘discontinued business treatment,’ as appropriate. This would involve the exclusion of losses and identifiable portions of the Business Indicator that are no longer relevant as a result of discontinuation of business and/or product lines. It would have the effect of eliminating the capital impact of loss experience and BI from divested businesses or businesses otherwise exited or, at the very least, mute the exposure given the absence of future risk, which is an important consideration given the lack of risk sensitivity.
- 3. **Insurance Mitigation** -- The Committee should recognize and incorporate prudent insurance hedging as part of the framework. A relatively simple example and approach would be the application of an aggregate “all risk” transfer program, with minimal exclusions, that applies as an offset to the overall SMA calculation, or as a post-SMA adjustment.
- 4. **Clarifications / Guidance** – Data input and/or treatment clarifications will be critical for consistent application of SMA, and may also be a factor in addressing pro forma result variances. Accordingly:
 - (a) The AMAG requests that BCBS and local supervisors specify what financial sources and standards to reference in formulating the BI. As but two examples, AMAG found significant differences in member sourcing from various financial reports, and also observed inconsistencies as to whether loss reserves and other operating expenses were included.
 - (b) Specifics will be needed on a variety of loss data collection and reporting issues that are not directly portable from AMA requirements. These should include, but not be limited to, confirmation that reference to ‘material timing losses’, ‘internal loss data clearly linked to a bank’s current business activities...’, and inclusion of external legal expense are well-defined, but are not intended to expand current industry practices toward collection and inclusion of loss data for capital purposes.
 - (c) FX Conversion -- Guidance should address a consistent approach to currency conversion of the underlying loss and BI data and/or of the framework's thresholds.

Detailed AMAG Findings and Observations

Pro Forma Calculations

In surveys about the Standardized Measurement Approach, as it was released and presented on March 4, 2016, AMAG member institutions were asked to develop pro forma calculations using the SMA formula provided. The results of this exercise were both surprising and troubling.

When compared to current regulator-approved capital under AMA, of those that provided both a regulator-approved Pillar 1 operational risk capital figure and a pro forma SMA Calculation, AMAG member institutions would have seen, on average, a 17.1% increase in capital for 2015¹. More specifically, 55% reported higher capital under their SMA calculation versus 45% that reported a lower SMA figure, while capital for only one member was largely unchanged. Of those that would have held more capital under SMA in 2015 versus their current regulator-approved AMA capital, the range of increase would have been between +3% and +47%, with a mean of +27.7%, and a median of +29.4%. The aggregate increase in capital for these institutions would have been \$26.7 Billion. Of those that would have seen a decrease in operational risk capital, the range of reduction would have been from 0% to -46%, with a mean of -20.1% and a median of -17.5%. The aggregate decrease in capital for these firms would have been \$3.4 Billion in 2015².

With these results as a backdrop, it is likely not surprising that the reaction of the AMAG membership is mixed. Thirty-two percent (32%) are opposed to the SMA as constructed and proposed, while an additional 31% are either undecided, or otherwise have reservations, for a combined total of 63% not in favor. Only twenty-six percent (26%) are in favor of the SMA as presented. It is important to note that there is not a strong correlation between those in favor and those calculating lower capital under SMA.

In view of the wide range of pro forma results, most AMAG members have serious concerns with the current calibration of the formula. The notion that U.S. regulators and financial institutions had confirmed agreed capital levels only recently under AMA and are now to abruptly substitute a new formula, which produces either an increase of as much as 47%, or a decrease of as much as 46%, would be unsettling to anyone. On the other hand it is understandable that based on whether their capital requirement increased or declined, some AMAG members might be opposed to such a proposal, while others might welcome

¹ Eleven (11) AMAG members provided both SMA and current regulator-approved AMA capital calculations. Note that AMAG tested the expansion of the sample size to include two (2) additional members who reported AMA capital, although are not yet regulator-approved under AMA, for a total of thirteen (13) banks. The result was largely unchanged, with a mean increase of 16.9%.

² When the AMAG sample is viewed by U.S.-domiciled and Canada-domiciled banks separately, of those U.S. banks calculating higher capital under SMA, the mean and median increases are 19.1% and 20.4%, respectively. Of those U.S. banks experiencing a decline, the mean and median reductions are -20.1% and -17.5%, respectively. The Canadian banks in our sample are seeing 44.8% mean and median increases.

it. Either way, such swings from what, arguably, had been a more risk sensitive model, to one that is far less so, are clearly troubling. At worst, the current SMA could have an unintended consequence, for some, of encouraging more risk taking. At best, the AMAG survey results imply, and AMAG supports, that additional work is needed by the Committee on calibration of the formula to reduce the variances between current AMA models and the proposed SMA model, and better align the results. The AMAG respectfully requests that following such recalibration that the industry be granted a second comment period of at least 30 days within which to respond.

The SMA Framework

As for the SMA framework overall, a significant number of AMAG members have expressed concern over what is essentially a decoupling of regulatory capital from operational risk management practices. In short, members are critical of a variety of implications including, but not limited to, the only-cursory recognition of risk profiles, its retrospective bias, and disconnect from a variety of operational risk management initiatives. See Exhibit B for further elaboration on these points.

Concerns that May be Addressed by Fine-tuning SMA

Following are the AMAG's observations that could be addressed in the context of specific enhancements to the SMA. They are organized in three sections, including commentaries on the Business Indicator, the Internal Loss Multiplier / Loss Component, and Other Priority Revision and Clarification Requests. Also in the following sections, and as Exhibit C to this letter, the AMAG offers responses to three specific questions raised by BCBS in its Consultative Document.

Business Indicator (BI)

The Consultative Document states that the "SMA capital requirements are anchored by a bank's BI Component, which is an increasing function of the BI. The BI Component was calibrated using QIS data collected by the Committee in the second half of 2015. Due to its calibration reflecting the aggregate experience of QIS banks, the BI Component reflects the operational loss exposure of an average QIS bank of a given BI size." The BI Component is defined as follows:

$$BI = ILDC Avg + SC Avg + FC Avg$$

Where ILDC is Interest, Lease and Dividend Component, SC is the Services Component and FC is the Financial Component. See the Consultative Document for formulaic definitions.

As the SMA is presented, its BI component is the main driver of operational risk capital. Simply stated, the larger the institution, the higher the BI and the larger the operational risk capital result. In fact, the BI component has a greater impact than the Loss Component and its multipliers. As an example, if for Bank A the BI is €5.7 Billion and there is no Loss Component, the internal loss multiplier is 0.54132, and the resultant SMA capital is €3.1 Billion. If, however, for Bank B the Loss Component is now €1 Billion while the BI remains at €5.7 Billion, the loss multiplier is 0.63854, and the SMA capital becomes €3.7 Billion. In essence, the SMA capital requirement is asymmetrical, and may be unreasonably conservative for banks such as Bank A with minimal losses, and likely more effective operational risk controls.

Clearly, the BI component is critical in SMA and, therefore, consistency of its measure is key. Based on discussions in AMAG industry forums, however, there are industry concerns that relate to data collection and issues resulting from definitional differences across accounting frameworks for, and ambiguity of, the primary BI line items. For one, the identification and selection of income statement items may be inconsistent across different banks due to various interpretations. A variety of common sub-items could easily result in lack of comparability across the banking industry. In addition, industry comparability and interpretation could be inconsistent due to different regulatory reporting and accounting standards globally.

SMA Business Indicator – AMAG modification requests: At a minimum, the BCBS and local supervisors should specify what financial sources and standards to apply in formulating their BI calculations. Exhibit D to this letter summarizes the results of a survey of members of the AMAG, and confirmed that members used different sources and assumptions when developing their pro forma SMA estimates. Among the examples, were different sourcing from general ledgers, U.S. SEC 10-K filings or FRB's FR Y-9C filings, as well as the inconsistent reporting of loss reserves, and other operating expenses. Certainly this issue is not limited to U.S.-regulated institutions and may also account for some of the variances in pro forma capital results.

The Internal Loss Multiplier (ILM) and Loss Component (LC)

As referenced in the Consultative Document, "The SMA builds on the assumption that the relationship between the BI and operational loss exposure is stable and similar for banks with similar values of the BI." The formulae for the ILM and LC are:

$$\text{Internal Loss Multiplier} = \ln(\exp(1) - 1 + \text{Loss Component} / \text{BI Component})$$

Where

$$\text{Loss Component} = 7 * \text{Average Total Annual Loss}$$

*+ 7 * Average Total Annual Loss only including loss events above €10 million*

*+ 5 * Average Total Annual Loss only including loss events above €100 million*

Loss Component impact and potential instability – AMAG members generally favor the inclusion of a loss component in SMA, but have a number of concerns about the Loss Component as developed and presented. Concerns shared by some, but not all, of the members of AMAG are outlined in Exhibit B. The following section, on the other hand, highlights issues raised almost universally by the broader AMAG membership.

- **Potential for Inconsistent Loss Accounting** – Many AMAG members have material concerns over issues that could produce inconsistent loss reporting and, therefore, have the unintended consequence of producing inconsistent comparability of capital results across the industry. As such, they should be addressed by the Committee.
 - **Accounting Recognition Dates** -- The first relates to the realized accounting dates. In view of the 10-year window for calculating the loss component, the selection of dates for the loss data must be consistent across the industry. On one hand, there is wide variation in the use of discovery dates. There is often a degree of judgment on what the discovery date should be, particularly for litigation in which an alleged activity occurred over some period of time, and various suits related to the activity may be filed over a period of years. Use of “impact” or accounting recognition dates, on the other hand, does not present these issues and aligns better to the dates on which the loss impacted earnings and capital. AMAG, therefore, believes that the SMA should permit the use of accounting dates only. Another particular benefit of the use of accounting dates is the recognition and adjustment large loss amounts over time. If all losses are applied as realized on an accounting basis, for instance, they will be included when realized, as reserves are set and adjusted, and cases are settled. This would aid in smoothing the capital impact of extraordinarily large losses in any given year. As such, an important advantage to using the realized accounting date is that it addresses concerns about possible stability of capital results in the future as large losses are captured and recognized in the SMA’s 10-year loss recognition window.
 - **“Material Timing Losses”** -- A second concern is that the SMA as proposed leaves the impression that it will adopt the rules of loss collection established for AMA, although it is not clear if the BCBS is intending to modify the types of losses that should be included in the Loss Component. One area of particular concern is a statement in the proposal that “material ‘timing losses’ should be

included in the SMA loss data set when they are due to operational risk events that span more than one financial accounting period and give rise to legal risk”. This statement is confusing and could be misinterpreted. Timing losses are typically captured for risk management purposes. The AMAG does not support inclusion of timing losses in the loss data for capital calculations, however. No justification is provided for expanding the current data scope to include timing losses. Adding timing differences to the traditional categories of loss events is unwarranted given that timing differences do not pose actual risk of loss nor do they represent a true financial impact on the institution; and the net impact over time is zero. They represent an accounting treatment only and do not impact the P&L statement the way that other loss events do, such as final damage awards, settlements, and the like. To be clear, any fines, penalties or legal cases or expenses associated with misreporting financial statements are an entirely different matter, and should be included in the loss data, but not an underlying timing difference itself.

- **“Linkage of Internal Loss Data”** -- A third loss-related concern with the Consultative Document is the statement that “Internal loss data are most relevant when clearly linked to a bank’s current business activities, technological processes and risk management procedures.” Does this statement intend to establish a different standard for when loss data can be removed from an institution’s loss history?
- **External Legal Expense** – Members note that there is also a range of practices related to how banks have included external legal expenses in their loss data sets. Some include them only when there is a reserve or settlement, but do not capture legal expenses when they prevail in the case. Other banks include external legal expenses even when they do prevail. These treatment differences can have a significant impact on the aggregation aspects of the SMA Loss Component computation.
- **Grouped Events** -- The treatment of “grouped events” as single events with one aggregate impact creates an issue with the 10-year rolling loss history, depending on what accounting date is chosen.
- **Direct Recoveries** – Last, clarity is needed to the treatment of direct recoveries.

In summary, specific guidance on losses appropriate for the SMA computation will be needed to achieve the twin objectives of consistency and comparability objectives.

- **Problematical €10,000 loss threshold** – The current industry standard for loss collection threshold is €20,000, as established through the ORX consortium of 89 banks globally. Firms must attest to robust controls for collection of losses at the €20,000 threshold. Granted, some may have established lower thresholds, especially those with frequent small losses in certain business lines, or smaller banks. Depending upon internal needs, banks have pursued varying levels of effort toward collection and tailored modeling of them. The fact remains, however, that because not all banks collect losses at €10,000, there will be lack of consistency in data quality and comparability at that threshold. Given that a key goal of the SMA is comparability, setting a higher threshold would provide better data quality and consistency industry wide. Industry experience shows that the smaller losses do not contribute much to industry capital-at-risk, but rather to expected loss. In addition, the level of rigor that would be necessary for regulatory reporting, especially for those not collecting at that level today, does not seem to be an effective use of resources that could be deployed toward risk management more effectively elsewhere. Last, high frequency smaller losses will have a very different (greater) impact on a capital approach such as SMA that considers the aggregation of losses. In contrast, the Loss Distribution Approach (“LDA”) under AMA represents losses not cumulatively, but, by definition, as a distribution. For these reasons, the BCBS should adopt and re-calibrate the SMA formula to the higher threshold.
- **Losses and BI for Discontinued Businesses** -- An inherent issue with the retrospective view that loss data represent arises as banks divest of and exit different businesses. Under SMA, loss exposures remain within the 10-year time horizon. As such, capital is effectively held to represent future loss events and related businesses for which a bank may have no current or ongoing risk of loss.

SMA Loss Component --- AMAG modification requests: (1) AMAG strongly urges the Committee to pursue financial statement recognition of losses. As a means of introducing greater stability of capital over time, large losses should be applied in the SMA formula as recognized on a bank’s financial statements (i.e., an initial reserve recognition, if applicable, with subsequent recognition of adjustments as they are realized). (2) Loss threshold – the Committee should set a higher threshold than €10,000 in order to provide better data quality and comparability, preferably at the €20,000 level. (3) Guidance will be needed on a variety of loss collection and reporting issues that are not directly portable from AMA requirements. These should include, but not be limited to, confirmation that reference to ‘material timing losses’, ‘internal loss data clear linked to a bank’s current business activities...’, and inclusion of external legal expense are clear and do not change current and established industry practices, except where noted above. (4) AMAG requests that the Committee allow banks to apply for a “discontinued business treatment”, as appropriate, which would include the exclusion of losses and aspects of the Business

Indicator that are no longer relevant as a result of discontinuation of business or product lines. This would eliminate the impact of loss experience from divested businesses or businesses otherwise exited. At the very least it would mute the exposure given the absence of future risk. (5) AMAG is divided on the question of eliminating the Loss Component breakpoints and recalibrating the SMA formula to apply its Loss Component to the 10-year average of total losses with a single loss multiplier. The Group would, however, generally be in favor of a feature that would scale existing breakpoints to better align to the size of institutions.

Additional Priority Revision and Clarification Requests

Recognition/inclusion of (insurance) mitigation benefit -- The proposal represents a missed opportunity to create incentives for pursuit of other prudent, risk-conscious behavior, such as the application of risk transfer insurance arrangements.

- **AMAG modification request:** The Committee should incorporate risk-transfer insurance hedging as part of the SMA framework. Specifically, one example would be the application of an aggregate all-risk transfer program, with very few policy exclusions, that applies as an offset to the overall SMA calculation, or as a post-SMA adjustment.

FX Conversions – The exchange rate impact and approach to BI buckets, losses, and other aspects may undermine comparability across jurisdictions, and should be addressed. There are several opportunities to convert FX within the calculation that will ultimately yield to variability across the industry.

- **AMAG Modification request:** Guidance should address FX Conversion of the underlying loss and BI data and/or the framework's thresholds.

Thank you, on behalf of the AMA Group, for the opportunity to submit these comments and suggestions on the Standardised Measurement Approach Consultative Document. The AMAG would be pleased to engage in a dialogue about its pro forma calculations and/or the observations in this letter. Please contact us should questions arise.

Respectfully submitted,

A handwritten signature in black ink, appearing to read "Edward J. DeMarco, Jr.", with a long horizontal line extending to the right.

Edward J. DeMarco, Jr.,
General Counsel and
Director of Operational Risk &
Regulatory Relations

Exhibit A

About the AMA Group

The Advanced Measurement Approaches Group (AMAG) was formed in 2005 by the Risk Management Association (RMA) at the suggestion of senior U.S. regulators. 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 AMA Group consists of operational risk management professionals working at financial service organizations operating in the United States. Institutional membership in the AMAG is open to any financial firm regulated in the U.S. that is either mandated, opting in, or considering opting in to AMA, and/or is required to conduct annual CCAR / DFAST exercises. A senior officer responsible for operational risk management serves as the primary representative of each member institution on the AMAG.

Of the institutions that are currently viewed as mandatory or opt-in AMA institutions, and/or CCAR/DFAST institutions in the U.S., twenty-six (26) are members of AMAG. The current members are listed below.

Bank of America	Keycorp
Bank of the West	M&T Bank
BB&T	Morgan Stanley
BMO Financial	Northern Trust
BNY Mellon	PNC
Capital One Bank	Royal Bank of Canada
Citizens Financial	Santander Bank
Credit Suisse	State Street
Deutsche Bank	SunTrust
GE Capital	TD Bank Financial Group
Goldman Sachs	Union Bank
HSBC North America	US Bank
JP Morgan Chase	Wells Fargo

Support for the AMAG is provided by RMA and Operational Risk Advisors LLC

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Exhibit B

AMAG Member Concerns about the SMA Proposal

The SMA Framework

As for the SMA framework overall, a significant number, although not all, of AMAG members have expressed concern over what is essentially a decoupling of regulatory capital from operational risk management practices. In short, members are critical of the SMA's lack of risk sensitivity, cursory recognition of risk profiles, retrospective bias, and assumptions about AMA elements and tools.

- **Shortcomings on Risk Profile/Risk Sensitivity/Retropective view** -- It is the sense of many AMAG members that in its development as a simplified approach, both risk sensitivity and prospective views on risk were sacrificed. This is deemed by many to be a significant shortcoming of the SMA. The methodology does not take institutions' risk profiles into consideration inasmuch as the capital calculation is primarily driven by the Business Indicator, and size of each bank. The method's only risk-sensitivity is limited to the historical losses that comprise its Loss Component. In essence, the SMA lacks a forward-looking view. It does not include prospective operational risk information or metrics gleaned from tools and elements developed and refined at AMA institutions over the past 10-15 years. Use of them would introduce more of a reflection of the firm's current control environment, and an indication of potential risk when coupled in the SMA. At best both Business Indicator (BI) and Loss component only take a present day or recent-past view into account, and at worst are essentially retrospective in nature.
- **Disconnected from Risk Management** -- Another consequence of its simplification is that the SMA severs the connection between risk measurement and business unit risk management. The SMA is a standalone capital measurement approach that will now be disconnected from enterprise-wide and business line-specific work toward a better understanding of the root causes of operational risk and subsequent management of operational risks. Although it will have use for simple capital estimation purposes, it will have less risk management relevance for business line management and staff members at large.
- **Assumptions about AMA Elements and Tools** -- A few members have voiced significant concern that the SMA proposal implies that investments and advancements in scenario analysis, Business Environment and Internal Control Factors ("BEICFs"), Risk Control Self-Assessments ("RCSAs"), reference to external loss data ("ELD"), and the like, are now deeply embedded at financial

institutions and not necessarily linked to AMA models. As such, it seems assumed that those programs will remain as resilient following the transition. Some have found it interesting for some time to observe differences in the advancements of those parts of the framework at AMA banks versus those banks that are not AMA-approved. Assuming that investment in these programs will continue with an equivalent level of rigor and enthusiasm in the absence of AMA is deemed optimistic by some. It is entirely possible that concern over abandonment or deterioration of these tools may be ameliorated somewhat in the U.S. given the presence of developing CCAR frameworks, but even here CCAR remains in its formative stages and currently only draws on some of those tools.

- **Abandoning Regulatory Unit-of-Measure Approaches** -- Others have voiced concerns that, under SMA, banks would no longer estimate regulatory capital on a unit-of-measure basis, which has been valuable for risk analysis. In addition, some use CCAR unit-of-measure loss projections as inputs to their risk-weighted asset ("RWA") forecast models. That would be abandoned under SMA as well.

The SMA Business Indicator

Many AMAG members agree that SMA should include a more risk-sensitive approach to the Business Indicator ("BI") beyond its simple measure of institution size. Apart from the Net Interest Margin ("NIM") cap at 3.5%, there is no differentiation for lower risk revenue streams. The AMAG is divided as to whether the Committee should pursue opportunities to improve the calibration of the BI scoring system. Some suggestions might include providing more benefit to firms that have larger sources of lower-risk advisory and/or service-based non-interest revenue. There may be an increase in frequency of smaller losses in such businesses, but the risk profile of the revenue stream is not necessarily linear, and should certainly not scale with higher multiples. In view of this, less risky revenue streams should not be subject to the same scaling factors and should not be increased with size of an institution. They should, arguably, decline with size. Such re-calibration changes would also provide some differentiation for strategic decision-making.

In addition, some AMAG member banks note that high-margin institutions may well be at a disadvantage as they will be required to hold higher capital in spite of a situation in which an institution has experienced relatively low loss levels. Some members also argue for revisiting the rationale for the 29% coefficient for bucket 5, and adjusting to a more reasonable level (note: marginal increase is 6 percentage points for bucket 5 vs. 4 percentage points for bucket 2 through 4).

As for the specifics of Business Indicator calibration, in the absence of sufficient transparency toward understanding the underlying framework, it is difficult at this stage

for the industry to judge the appropriateness of its parameters. Further transparency on the SMA calibration process would be helpful and appreciated in this regard.

The Loss Component

Loss Component impact and potential instability – AMAG members generally favor the inclusion of a loss component in SMA, but have a number of concerns about the Loss Component as developed and presented. Following are among the concerns voiced by various members.

- **Unclear Rationale as to Calibration of Specific Multipliers** – The Loss Component is sensitive to inclusion and exclusion of losses due to the built-in breakpoints and multipliers (i.e., Losses above €100 million are multiplied 19 times while losses above €10 million are multiplied 14 times. Losses below €10 million are multiplied 7 times). Although the AMAG is supportive of including a loss factor, the methodology and its multipliers serve to penalize even institutions that have suffered a single large loss with an outsized capital charge because it would be counted multiple times in the calculation. A loss over €100 million, for instance, would be counted over 3 times (i.e., in each of the loss tiers). Another concern is that the proposal's thresholds are not set proportional to the size of an institution. This tends to complicate the formula in pursuit of an unclear objective. Losses above €10 million and €100 million will have far differing relevance to the largest AMAG institutions than to the smallest in the group, and vice versa.
- **Lack of Transparency** -- It is extremely challenging, if not impossible, to gain comfort over the appropriateness of the loss multipliers due to the lack of transparency concerning the data and methodology used in developing them. Initial reviews and AMAG member pro forma SMA calculations demonstrate that the proposed levels may generate disproportionate Loss Component results in respect to firms' average historical yearly losses, and current level of operational risk capital.
- **Internal Loss Multiplier ("ILM") Baseline** – Some have observed that the lower bound of the ILM (i.e. $\ln(\exp(1) - 1) \approx 0.541$) is set at a very high level. Even in the extreme case of no operational loss, the loss multiplier ensures that the amount of operational capital is about 50% of the BI Component. The multipliers (7x and 5x) in the logarithmic function ensure a high correlation between the internal loss multiplier and capital requirements.
- **Missed LC risk sensitivity opportunities** -- Although the Loss Component represents a step toward building some risk sensitivity into the formula, its focus on aggregate losses dampens its potential as a risk measure. First is the possible

volatility that may be produced by the 10-year window for losses and its potential cliff effect thereafter. That is, there could be a volatility of results as large losses drop off at the end of the window. Second, the SMA's 10-year time horizon is not aligned with risk sensitivity or changes in risk profile. Some, but not all, of AMAG members believe that the Committee could weigh the loss years in the 10-year LC window differently in order to provide some additional risk sensitivity. Recent losses could be given more weight as they better reflect the current business operations and environment. Similarly, older losses (i.e., in the 7-to-10-year range, for instance) should be assigned a lower weighting. Third, SMA does not differentiate between the loss frequency and severity of an institution's loss history. Greater loss frequency, for instance, can be a better indicator of risk, whereas infrequency can be indicative of better controls. Severity can be more random and not necessarily indicative of poor controls, unless of course, it is associated with moderate-to-high loss frequency. Fourth, although Section 6.1 of Consultative Document requires very detailed loss data identification, collection, and treatment, these requirements are not applied effectively in the SMA capital measurement process. For example, there is no differentiation between risk events and business lines in the SMA capital measurement.

- **Loss of External Loss Data (ELD) Reference Value** – Some members argue that another important shortcoming of SMA is the omission of industry data with which to use as a gauge to assess the reasonableness of capital estimates. The rationale for using ELD is well known. Bank A operates in the same business activity as a peer group but has somehow been fortunate enough to have avoided the substantial losses from a particular risk that its peers have incurred. The capital estimate for Bank A should at least consider that risk and those industry losses, even though a loss resulting from that particular risk is not in Bank A's own loss history. For the SMA to omit ELD is to almost impugn the influence of ELD on a bank's risk profile and operational risk capital estimate. Going forward under SMA, at the very least the Committee should continue to encourage use of ELD for risk management purposes.

Exhibit C

BCBS Questions

The BCBS posed three questions in its Consultative Document, as follows:

- 1. What are your views on the revised structure and definition of the BI?*

AMAG collective response: See AMAG commentary on p. 5 of this letter, as well as in Exhibits B & D.

- 2. *What are your views on the inclusion of loss data into the SMA? Are there any modifications that the Committee should consider that would improve the methodology?***

AMAG collective response: See AMAG commentary on pp. 6-8 of this letter, as well as in Exhibit B.

- 3. *What are your views on the example of an alternative method to enhance the stability of the SMA methodology? Are there other alternatives that the Committee should consider?***

AMAG individual member responses – This question was included in a recent AMAG survey. On balance the AMAG members who opined on the Annex 2 are either indifferent to the proposal, referencing it as a ‘secondary issue’, believe it will have minimal impact, or do not believe that they have enough information to judge. One is firmly opposed and one is mildly in favor, as outlined below:

- a) “The stability of the SMA methodology is important, but secondary to addressing the current shortcomings of the formula and parameterization, particularly in respect to the Loss Component. In addition, we expect that the range of parameters that will be allowed by regulators, for example in Annex 2, would not provide much progress in terms of stability compared to the main formula.”
- b) “If the factor to be calibrated, “m”, is in the range of 2.5 to 3, then the alternative will yield results that are very similar to the main proposal over a wide range of LC to BI Component ratios. Thus, whether the main proposal or alternative is selected would not be very important. It would be helpful if the BCBS could elaborate on what realistic problem the alternative solves. The BCBS should provide a specific value for the factor “m” in order to facilitate thoughtful discussion of the alternative.”
- c) “The approach in Annex 2 is a bad idea since it's not a smooth function at all (e.g., it has singularity around 0.5 when LC is close to BI). There are logit functions that may be considered in order to have a lower bound but also an upper bound.”
- d) “Overall, reducing volatility is a good thing. Current SMA approach already addresses that though.”
- e) “(i) The alternative method has not mitigated the conservatism in the proposed internal loss multiplier. If there is no loss component, the

capital requirement will be 50% of the BI component. (ii) The alternative method is a decreasing function of m (i.e. if m increases while both BI and loss component remain constant Capital will decrease)."

- f) "We support anything that makes the SMA calculation more risk sensitive, but have no specific comment on the proposed alternative method."
- g) "(i) Regarding Annex 2, there is no clarity around how " m " is calibrated and thus we are not able to assess the formula and its impact. (ii) Another alternative is to incorporate, in addition to ILED, a loss forecast component through modeling severity/frequency distribution and scenarios analysis. Thus, most recent ILED can be used in the formula, e.g. historical losses observed through past 3 years, instead of 10 years of ILED. The forecast component will increase risk-sensitivity."
- h) "The possible range for m , the multiplier, must be clarified before we can opine on this method."
- i) "It is necessary to understand the variable " m " in order to compare one method to another. However, there is no reason that one method is more stable than the other in reviewing these alternatives."
- j) "Consider weighting operational losses so that recent years count more - which would reduce capital volatility caused by older losses rolling out of the calculation."
- k) "This seems like a reasonable approach. At this point in time we have no other alternatives to offer."
- l) "At this time the alternative formula has an unknown factor to be calibrated at a later date. Without guidance on a possible range for this factor, we noticed a possible low value where the denominator equals zero and could pose potential problems."
- m) "Method uses a factor = " m " (to be calibrated to adjust the LC), and then multiplies it by the BIC. Currently a value of $m=2.23$ equates to the Loss Multiplier of 110% for 2015 data. While this methodology reduces the volatility of the Loss Multiplier, without understanding the conceptual basis of the proposed calculation or the alternative, it is difficult to comment."
- n) "The appeal of the Annex 2 methodology rests entirely on the calibration of M , as we believe the formula otherwise yields similar outcomes. (Regulators implied) that Annex 2's calibration is aligned with the proposed SMA when $M=3$. As such we would not prefer Annex 2 unless M is less than 3."

Exhibit D

The Business Indicator:

Observations on BI data input Inconsistencies

In view of members' concerns about potential inconsistencies in data reporting for the BI calculation, AMAG conducted a survey of its membership on approaches pursued. The findings, excerpts of which are outlined below, indicate that significant clarification and guidance will be necessary.

1. **Primary Data Sources:** When asked for their primary data sources referenced in calculating the BI, 60% cited their General Ledger, 20% indicated that it was their Securities and Exchange Commission (SEC) 10-K disclosure under US GAAP, 10% referenced their FR Y-9C disclosure, and 10% said it was their QIS submission.
2. **Types of expenses included in "Other Operating Expenses":** 10% indicated that they included loss-related expenses excluding reserves; 20% used loss-related expenses excluding reserves, but including other operating expenses; 20% used loss-related expenses, including reserves; and 40% used loss-related expenses including reserves, as well as other operating expenses.
3. **Among the Line Items presenting difficulty to break out:** 50% of members pointed to difficulties involving fee and commission expenses, 60% cited net profit (loss) on financial operations (trading book), 50% said net profit (loss) on financial operations (non-trading book), 50% referenced other operating income, 60% said other operating expenses, 40% indicated that it was operating leasing income, and 50% said operating leasing expense.
4. **Challenge in backing out or omitting P&L items to be excluded per paragraph 46 of Annex 1?** 50% of members indicated that this was a challenge.
5. **Where was hedge accounting, included in bank BI, and do members include amounts that flow through the Other Comprehensive Income (OCI)?** 20% indicated that they did not include hedge accounting, and 20% indicated that they did not include OCI. Among others responding, one indicated that they did not consider breaking down the interest income to hedge accounting, another stated that fair value (FV) gains and losses on their FV hedges are included in the 'Interest expense' and so absent and adjustment would be part of the ILDC

component, a third said that for OCI, only the items that flow through the P/L are included in the BI calculation, a fourth said that hedge accounting was included with the financial component of the BI calculation as it reported with the income statement, and a fifth said they included cash flow hedges for the net P&L banking book.

6. **Issues encountered in reporting certain items on a gross vs. net basis?** 30% indicated that they did encounter issues. Examples: “fee income and expenses” and “automated feeds from the GL to the op loss database creates some challenge in reporting gross vs. net.”