



State Street Corporation

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

Via electronic submission: www.bis.org/bcbs/commentupload.htm

Consultative Document – Standardized Measurement Approach for Operational Risk

Dear Sir/ Madam:

State Street Corporation (“State Street”) welcomes the opportunity to comment on the consultative document (“consultation”) issued by the Basel Committee on Banking Supervision (“Basel Committee”) regarding revisions to the regulatory capital framework for operational risk. Following an initial consultation in October 2014, the Basel Committee proposes the introduction of a new Standardized Measurement Approach (“SMA”), which combines a simple financial statement-based proxy of size and activity (*i.e.* the business indicator) with a banking entity’s internal loss experience over a ten-year horizon (*i.e.* the loss indicator) in order to determine required amounts of operational risk capital.¹ In addition, the Basel Committee affirms its intention to abandon the use of the internal models-based Advanced Measurement Approach (“AMA”) for operational risk, with the timeline for the withdrawal of the AMA and the implementation of the SMA to be determined in 2016 based upon a combination of industry feedback during the consultation period and the results of a forthcoming quantitative impact study.

As an initial matter, we would like to thank the Basel Committee for the thoughtful and deliberate manner in which it has approached its policy mandate. This includes its recognition

¹ ‘Consultative Document: Operational Risk – Revisions to the Simpler Approaches’, Basel Committee on Banking Supervision (October 2014).

of the material limitations of the AMA in its current form and its willingness in two rounds of public consultation to consider the design of an alternative standardized approach which balances the need for a simple, stable and comparable view of operational risk capital with appropriate risk-sensitivity. This also includes an industry hearing with the Basel Committee's Working Group on Operational Risk, where State Street and other market participants were afforded the opportunity to provide their views on the design and calibration of the intended SMA.² We have, in this respect, participated in the development of the responses prepared by various financial services trade groups, notably the joint submission from The Clearing House Association, The Financial Services Roundtable and the Securities Industry and Financial Markets Association, and we broadly support targeted efforts to improve or clarify certain features of the SMA.

Our intention with this letter is to emphasize our strong support for the Basel Committee's decision to abandon the use of the AMA for operational risk and its replacement with a new standardized approach. Furthermore, we see little value in prolonging the use of internal models for the estimation of operational risk capital and therefore recommend that the Basel Committee proceed with the implementation of the SMA with only a brief transitional period, and that it permit early adoption of the SMA by those banking entities capable of immediate implementation.

Headquartered in Boston, Massachusetts, State Street is a stand-alone custody bank that specializes in the provision of financial services to institutional investor clients. This includes investment servicing, investment management, data and analytics, and investment research and trading. With \$26.8 trillion in assets under custody and administration and \$2.3 trillion in assets under management as of March 31, 2016, State Street operates in 30 countries and in more than 100 geographic markets. State Street is organized as a United States BHC, with operations conducted through several entities, primarily its wholly-owned insured depository institution ("IDI") subsidiary, State Street Bank and Trust Company. As a stand-alone custody bank, we derive a substantial amount of our revenue from fee-based services rather than from the generation of yield from credit risk assets. For instance, as of March 31, 2016 fee-based revenue comprised 79.3% of our total revenue. Similarly, we make relatively few loans and we do not engage in significant trading or other capital markets activity. As of March 31, 2016, our Basel III advanced approach common equity Tier 1 ("CET1") ratio was 12.3% and our Basel III standardized approach CET1 ratio was 12.5%. Our estimated *pro forma* supplementary leverage ratio equaled 6.2% at the level of the BHC and 6.4% at the level of the IDI.

The Basel Committee first introduced the AMA in 2006, an approach which requires banking entities to estimate their operational risk capital using supervisory approved internal models calibrated at a 99.9% confidence interval across at least seven discrete event risk categories, or 'units of measure' ("UOM"), using a combination of internal and external loss data. As such, for UOMs with limited internal data, external data pooled from across the industry has become the

² May 17, 2016 in Basel, Switzerland.

primary driver of internal model-based outcomes. There are, in our view, several fundamental flaws with this approach. First, the requirement to extrapolate operational losses to the 99.9% confidence interval and the broad dependence on external data, has led to extremely fragile internal models heavily influenced by outsized industry events. This results in a highly unstable operational risk framework, subject to a pronounced ‘ratcheting effect’ of required amounts of capital, unrelated to a banking entity’s own loss history. As an example, State Street has experienced an almost 60% increase in its operational risk capital over the past three years (from 2013 to 2016), driven almost exclusively by the impact of external loss events.

Second, the structure of the AMA leads to tremendous variability in capital outcomes among banking entities based on small differences in the parameterization and use of internal models, unrelated to the entity’s actual loss experience. Similarly, differences in the interpretation and application of the AMA across national jurisdictions have led to broadly divergent capital outcomes which prevent the meaningful comparison of data on an industry-wide basis. We therefore strongly support the Basel Committee’s decision to abandon the use of internal models for the estimation of operational risk capital. Furthermore, we strongly support the introduction of the SMA as a simple, predictable and consistent standardized alternative. Key in this respect is the Basel Committee’s decision to incorporate within the SMA the internal loss experience of each banking entity as a central component of the loss estimation process.

Notwithstanding the substantial investments which the industry has made in the development of the AMA, we do not believe that it is necessary to provide the industry with a lengthy implementation timeline for its replacement with the SMA. This is true for three reasons. First, given the inherent volatility of the AMA, any implementation delay is likely to lead to further large swings in operational risk capital for many banking entities, unsupported by actual loss experience, thereby aggravating the negative implications of an already discredited framework. Simply put, if experience has taught the industry and the supervisory community that the AMA is unworkable and produces highly volatile, unreliable and inconsistent capital estimates, then continued use of the AMA, even on an interim basis, is misleading and unjustified.

Second, the SMA is quite simple to implement and therefore does not require the type of information technology and internal systems upgrades that would otherwise warrant a lengthier phase-in period. This is especially true since work by the Basel Committee on a revised standardized measure of operational risk has been under discussion since October 2014, a period of more than 18 months. Finally, given the importance of predictability in the management of a banking entity’s regulatory capital and the broad-based uncertainty that the industry is already facing due to the Basel Committee’s ongoing review of the Basel III framework, we believe that timely adoption of the SMA would introduce a necessary measure of stability in the capital planning process.

We therefore urge the Basel Committee to finalize the SMA without delay, and believe that it should only provide for a brief transitional period away from the internal models-based AMA. Furthermore, we recommend that the Basel Committee permit early adoption of the SMA by banking entities capable of timely implementation, subject to supervisory review and approval.

CONCLUSION

Thank you once again for the opportunity to comment on the important matters raised within this Consultation. To summarize, we strongly support the Basel Committee's decision to abandon the use of the internal-models based AMA for the estimation of operational risk capital and its replacement with the SMA. This reflects the substantial limitations of the AMA in its current form, notably its tendency to produce highly unstable capital outcomes which bear little to no relation to the loss experience of individual firms. This also reflects the value of the SMA as a simple, stable and comparable standardized alternative, with an appropriate degree of risk-sensitivity. Furthermore, we do not believe that the industry requires a lengthy implementation period for the abandonment of the AMA, and therefore recommend swift adoption of the SMA, along with the ability for banking entities to early adopt, subject to supervisory review and approval.

Please feel free to contact me at akuritzkes@statestreet.com should you wish to discuss State Street's submission in further detail.

Sincerely,

A handwritten signature in black ink, appearing to read 'A. Kuritzkes', with a stylized flourish at the end.

Andrew Kuritzkes