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

Re: Basel Committee on Banking Supervision Consultative Document – Standardized Measurement Approach for Operational Risk

Ladies and Gentlemen:

Wells Fargo & Company (“Wells Fargo” or “we”) is a diversified financial services company with over \$1.8 trillion in assets providing banking, insurance, trust and investments, mortgage banking, investment banking, retail banking, brokerage services and consumer and commercial financial services. We appreciate the opportunity to comment on the Basel Committee on Banking Supervision (“BCBS”) Consultative Document: *Standardized Measurement Approach for operational risk* (the “Proposal”).

We have worked closely with several trade organizations in reviewing the Proposal. We generally share the concerns identified in the comment letters filed by The Clearing House Association L.L.C. (“TCH”), American Bankers Association (“ABA”), Advanced Measurement Approaches Group (“AMAG”) and the Institute of International Finance (“IIF”).

Executive Summary

We agree with the BCBS’s objective to ensure greater consistency in regulatory capital outcomes through the implementation of post-crisis regulatory reforms. Consistent with that objective, the BCBS assessed the Advanced Measurement Approach (“AMA”) framework for operational risk and concluded its inherent complexity and lack of comparability arising from a wide range of observed practices resulted in significant variability in risk-weighted asset calculations. Hence, the BCBS determined that “withdrawal of the internal modeling approaches for operational risk regulatory capital (i.e. the AMA) from the Basel framework was warranted.”¹ We believe that the AMA was continuously improving to more accurately capture operational risk exposure and better estimate operational risk regulatory capital. However, we also understand the complexity associated with effectively completing all of the AMA framework requirements in a manner consistent with the expectations of the BCBS, and local supervisors, has posed a challenge to many institutions. Consequently, we accept the elimination of the AMA for regulatory capital purposes and development of a standardized approach to measuring operational risk capital. We believe a standardized approach should be designed to achieve balance between the BCBS’s objectives of simplicity and comparability, while maintaining sufficient risk sensitivity to reflect a bank’s operational risk profile. We do not believe the proposed SMA appropriately strikes this balance due to its lack of risk sensitivity. Oversimplification of the standardized methodology and decoupling of operational risk

¹ <http://www.bis.org/bcbs/publ/d355.pdf>. Page 1, #2.6

management from operational risk measurement could potentially cause the operational risk capital charge to simply turn into a size-based capital surcharge.

A summary of our concerns with the Proposal and recommended improvements, which are discussed in more detail below, are as follows:

- The empirical evidence used to calibrate the SMA is not transparent;
- The Business Indicator (“BI”) calculation methodology and disproportionate weighting toward the BI creates undue emphasis on entity size; and,
- The proposed methodology for calculating the internal loss multiplier is unnecessarily complex.

Details Regarding Our Primary Concerns and Recommended Improvements

- The empirical evidence used to calibrate the SMA is not transparent: The lack of visibility into the underlying data, methodology and model used to calibrate the SMA make it unclear whether the SMA achieves its stated purpose. The SMA relies on the combination of historical measures of entity size and losses to provide an estimate of future risk. Without the underlying support, it is not clear why these two components and the relative weightings of each are representative of operational risk. The Proposal indicates analysis was completed by the BCBS, which supports the BI calibration, stating, “the progressive increase of the marginal impact of the BI is motivated by analysis which showed that operational loss exposure increases more than proportionally with the BI.” With respect to the loss component (“LC”), the Proposal states, “Analysis conducted by the Committee supports the introduction of historical loss experience as a relevant risk indicator of future operational risk loss exposure.” The underlying analyses are not provided in either case. These analyses are essential to support the underlying methodology suggesting size and historical losses are appropriate measures to estimate operational risk.

The Proposal also states that one of its objectives is to “not significantly increase overall capital requirements.” However, an impact study recently carried out by ORX (Operational Riskdata eXchange Association) indicates 75% of the banks surveyed saw an increase in Pillar I operational risk capital under the SMA, with a median increase of 33% and mean increase of 61%. We recommend the BCBS consider the ORX survey results in determining the final calibration of the SMA to ensure the results are consistent with the BCBS’s stated objective.

The lack of transparency surrounding the analysis supporting the SMA formula coupled with the BCBS’s desire to maintain current capital levels suggests the SMA may not be durable over the long-term. While we trust that the BCBS will adjust the calibration consistent with its stated objective, the lack of transparency surrounding the calibration make the SMA formula susceptible to change at a future date if the BCBS’s desired capital levels are no longer consistent with the SMA outcomes. Consequently, we reiterate our recommendation for transparency regarding the calculation of the final calibration and would also recommend the BCBS provide an expected timeline for periodic review and adjustment of the calibration. We recommend a periodic review occur every 3-5 years, and that the calibration remains unchanged between each periodic review.

- The BI calculation methodology and disproportionate weighting toward the BI creates undue emphasis on entity size: The proposed SMA is disproportionately weighted towards size without

sufficient acknowledgement of differences in business model or portfolio composition. In other words, two banks which may be of the same size (measured based on assets or revenue) would hold the same level of capital despite the composition of their business products and activities generating very different risks. A potential remedy to this bias would be to consider calculation of capital at the business segment or product level and thereafter, aggregating the capital from each business or product segment. Applying the SMA in this manner would more appropriately weight the size and loss characteristics for each distinct product line without significantly increasing the complexity.

In addition to the limited differentiation based on business activities, the SMA calibration is more heavily dependent on the BI than the LC. For example, a 10% annual increase in the BI component would result in a 6% increase in SMA capital, whereas a 10% annual increase in the LC component would only increase SMA capital by 4%. The BCBS's stated rationale for including the LC based on the bank's own loss history is to increase risk sensitivity and to provide an incentive for strong operational risk management. While we believe the historical nature of the proposed LC is not predictive, we would support greater weighting of the LC. As discussed above, the proposed BI lacks risk sensitivity due to its limited recognition of business model and backward-looking nature. As a result, we believe greater weighting toward the LC component would enhance risk sensitivity and create stronger incentives for continuous improvement in operational risk management. Without clearer information regarding the current calibration, we are unable to suggest a change to the existing calibration that would produce an acceptable outcome; however, we recommend the BCBS closely consider both the capital outcomes and policy objectives in arriving at the final relative weightings of the BI and LC components within the SMA.

Due to the backward-looking nature of both the BI and LC components of the proposed SMA, losses from businesses or operations that have been discontinued, or exited, may no longer represent the future operational risk for a bank. As such, when a product or line of business is exited or sold, the related losses should be allowed to be excluded from the historical losses used to calculate capital for future periods. Because the Proposal already relies heavily on accounting concepts, the BCBS could consider the discontinued operations threshold set forth in U.S. GAAP as a basis for excluding historical losses from the LC.

- The proposed methodology for calculating the internal loss multiplier is unnecessarily complex: Requiring a separate loss multiplier for losses in different size buckets and grouping of losses into a single loss event creates a number of complexities that will invariably distract from other productive risk management activities. The total amount of losses associated with a single grouped loss event are subject to change over time as more information becomes available regarding the event and related events. It is not clear in the Proposal how an event that migrates from one bucket to another over time (e.g. due to changes in accrued losses, realization of actual losses, or grouping of multiple losses) would be treated in calculating the LC. Grouping losses into a single loss event for bucketing purposes, along with recognizing multiple loss amounts in different years within the 10-year history creates inherent complexity as the losses associated with the grouped event roll on and off of the 10-year history. We foresee significant debate around grouping methodology that could be avoided by eliminating the bucketing in favor of a single multiplier. The proposed loss multipliers vary from 7-19 depending on the applicable loss bucket. Instead, we recommend a single multiplier in the range

of 12-15, with the ultimate calibration based on the QIS results. While a single multiplier is arguably less risk sensitive, we believe the benefits provided in reduced complexity may outweigh the risk sensitivity provided by arbitrary, absolute euro loss bucketing. If the BCBS does not consider our recommendation for a single multiplier, we recommend that the BCBS provide very clear definitions of operational loss and loss event to reduce ambiguity around the grouping of losses and bucketing of loss events.

If the BCBS proceeds with a loss bucketing approach, we recommend adjusting the levels of the loss buckets based on the relative size of the bank before being subjected to the existing proposed multipliers. Introducing an incremental capital charge for large losses without grounding the framework based on the relative size of the loss disproportionately impacts large banks. The rationale behind the incremental charge for large losses is not clearly articulated and it provides diminishing returns in incenting risk management because it is not calculated based on a relative basis. To address these concerns and achieve alignment to the proposed BI methodology, we recommend separate loss thresholds that correspond to the BI buckets. We propose thresholds applied as shown in the table below:

Proposed BI buckets with corresponding LC multiplier thresholds			
Bucket	BI Range	LC multiplier threshold	
		Low (7x multiplier)	High (5x multiplier)
1	€0 to €1 bn	€2 m	€20 m
2	€1 bn to €3 bn	€4 m	€40 m
3	€3 bn to €10 bn	€10 m	€100 m
4	€10 bn to €30 bn	€25 m	€250 m
5	€30 bn to ∞	€50 m	€500 m

This solution will not address the complexities we foresee in the loss event identification and loss bucketing process. However, increasing loss multipliers to correspond with the BI buckets would better reflect the relative size of a bank's losses and support the BCBS objective of incenting risk management without significantly increasing complexity.

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In summary, we encourage the BCBS to consider our comments and recommendations described herein as well as share the underlying data, methodology and calibration prior to finalizing the guidance. We believe the investments made in creating the AMA infrastructure (e.g. data, scenario analysis, risk assessments, modeling) have afforded us the ability to better understand operational risk, and have gone a long way in informing our risk management capabilities and the appropriateness of capital held for operational risk exposure. While these elements may no longer form part of the framework to calculate

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operational risk regulatory capital, it would be helpful to have clarification on where the BCBS believes these activities should reside within the Basel framework.

We appreciate the opportunity to comment on the issues contained in the Proposal. If you have any questions, please contact me.

Sincerely,



Joseph J. Rice
Executive Vice President and Chief Operational Risk Officer

On behalf of:

Michael J. Loughlin
Senior Executive Vice President and Chief Risk Officer