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March 23, 2007

Office of the Comptroller of the Currency
250 E Street, SW, Mail Stop 1—5
Washington, D.C. 20219

Ms. Jennifer J. Johnson, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, D.C. 20551

Mr. Robert E. Feldman, Executive Secretary
Attention: Comments RIN 3064 - AC73
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, D.C. 20429

Regulation Comments
Chief Counsel's Office
Office of Thrift Supervision
1700 G Street, NW
Washington, D.C. 20552
Attention: No. 2006 - 33

Industry Response to
Notice of Proposed Rulemaking
Risk-Based Capital Standards
OCC Docket Number 06-09
FRB Docket Number R-1261
FDIC RIN 3064 – AC73
OTS No. 2006-33

Ladies and Gentlemen:

On behalf of the Advanced Measurement Approaches Group (AMAG)[1], I am writing to convey our industry Group's response to your Risk Based Capital Standards: Advanced Capital Adequacy Framework – Proposed Rules and Notices.

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[1] The Advanced Measurement Approaches Group (AMAG) was formed in mid-2005 at the suggestion of the U.S. Inter-Agency Working Group on Operational Risk. The AMAG is open to any banking and/or financial institution regulated in the United States that is either mandated, opting in, or considering opting in to Basel II. A senior officer responsible for operational risk management represents each member institution on the AMAG. Of the twenty-two or so US banking institutions that are currently viewed as mandatory or opt-in Basel II institutions by the U.S. regulatory Agencies, fifteen are currently members of the AMAG. The Risk Management Association (RMA) provides the secretariat for the AMAG.

The AMAG supports the Advanced Measurement Approaches (AMA) under Basel II and its fundamental goals of improving operational risk management practices and ensuring capital adequacy. To achieve these goals, the AMAG believes that first and foremost the AMA should promote flexible principles-based and risk-based methods for estimating capital and managing operational risk. Second, the AMAG strongly believes that a proper balance between management and quantification must be attained.

With these positions as background, we commend for your consideration our comments on several aspects of the Rule, Notices and Supervisory Guidance that are deemed of the highest priority to our members. We should note that although this letter and attachment reflect the collective view of the AMAG, it does not necessarily reflect the individual view of all members of the AMAG, and it is in no way intended to supercede the responses or priorities of any individual member, as outlined in their own response(s) to the proposed rule and Supervisory Guidance.

Although in agreement with much of the text, the AMAG disagrees with some of the proposed rules, particularly those that imply a level of precision that does not yet exist, given the relative immaturity of the operational risk measurement discipline and the relative paucity of loss data in a number of areas. First, there is a notable lack of flexibility in the rules that would, in effect, disallow otherwise viable modeling approaches to determine Units of Measure. Second, the expectations laid out for the measurement of *dependence* seem unrealistic. Third, the restrictions on allowable offsets for Expected Operational Losses (EOL) are too narrowly defined. In combination, these three issues have the potential effect of causing capital estimates to not be defensible by the members on an individual bank level.

Following are highlights of our response; further details are contained in the attachment to this letter:

- **Unit of Measure:** This NPR language and the language of Standard 27 itself are not consistent with the explanation that follows the Standard. The text would be clearer if it deleted the contradictory language about different risk profiles within a loss distribution and re-defined Unit of Measure to replace the word *distribution* with the word *measure.*

- **Dependence:** It would improve both texts to define dependence as "*... a measure of the association among operational losses across and within units of measure.*" Second, the requirement to demonstrate that the process of estimating dependency meets several criteria should be based on empirical evidence that is currently available, whether it is statistical or anecdotal. Third, both drafts should delete any generalization regarding top-down approaches and the masking of dependence and assumption of statistical independence.

- **Expected Operational Loss / Unexpected Operational Loss:** On the subject of reserves, the EOL language should be modified such that allowable reserves for offset would include those that are more general in nature, but are set aside for relatively small, predictable, legal loss event types (e.g., addressed by legal reserves). In addition, the AMAG believes that budgets for loss events that, too, represent "highly predictable and reasonably stable operational losses" be allowed for offset.

- **Disclosures:** The AMAG requests clarification of instructions for completing Schedule V, and / or changes as described in the enclosed attachment. For instance, Items 3-7 in the Public Disclosure section should be moved to the section entitled *Confidential.* Under current industry practices, these items are not publicly disclosed.

- **Reservation of Authority:** Remedies already exist under Pillar 2 to address situations where capital requirements are believed by regulatory agencies to be understated. As such, the AMAG believes that this language should be stricken from the rule and the agencies' concerns should be addressed under Pillar 2.

In addition, we offer responses to several questions in the NPR (also see attachment):

- **Question 19:** Part (i) - To the extent that a definition is necessary, the proposed wording is acceptable to most AMAG members. Some request, however, that the NPR *not* include a prescriptive definition of "operational loss". Part (ii) - the AMAG generally believes that the definition should remain tied to direct financial effects on banks' regulatory capital over a one-year time horizon. Part (iii) - In order to avoid double counting, the additional capital requirement associated with the risk-weighted asset approach to bank premises should be removed. That is, eliminate the calculation of capital based on risk-weighted assets under section 31(e)(3) of the proposed rule. The risk of loss from damage to physical assets should be included only in Operational Risk Capital.

- **Question 28:** The AMAG believes that additional discussion would be needed on this issue, along with evaluation of numerous illustrations considered beyond the single example cited in the NPR.

- **Question 29:** The AMAG supports treating operational losses that are related to market risk as operational losses for purposes of calculating risk-based capital requirements; however, here too, the AMAG believes that additional discussion would be needed on this issue.

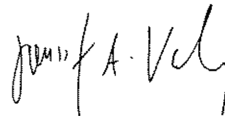
- **Question 60:** The AMAG believes that the rule gives a rather limited perspective on what losses could be defined as highly predictable and routine and, therefore, allowed to offset EOL. From the point of view of a large, complex, banking institution with sophisticated risk management processes, predictable losses could encompass all business lines and event types, and therefore the loss event types considered predictable in the rule should not be restrictive.

Enclosed with this letter is an attachment that outlines the Group's positions in detail, including references to the text of the Rule and Supervisory Guidance, where applicable, discussion of each issue, suggestions for improvement, and comments about implications of the suggested revisions.

Last, but not least, we are compelled to share an overarching concern that inconsistencies appear to have arisen between the text of the proposed rule and the recently issued Supervisory Guidance, as well as within the Supervisory Guidance itself. As such, AMAG members find themselves seeking clarification as to which of the texts will govern the rules in question. Where relevant we have highlighted examples of inconsistencies, along with our specific issue above, and in the attached detailed discussion. The AMAG believes that those inconsistencies must be addressed by the agencies prior to finalizing the Rules.

Representatives of the AMAG would be pleased to meet with representatives of your agencies to discuss our comments on the proposed rule and Supervisory Guidance, if desired and deemed to be mutually productive. In the interim, please contact me at (704) 712-1349 should questions arise regarding this letter, attachment, and / or the AMAG.

Sincerely,



Yousef A. Valine
Chair, *Advanced Measurement Approaches Group* (AMAG)

Enclosure: AMAG Attachment: NPR Response Detail

AMA Group Signatories:
Bank of America
Bank of New York
Citigroup**
Comerica
Goldman Sachs
HSBC
JP Morgan Chase**
KeyCorp
Sovereign Bank**
State Street Bank
SunTrust
Union Bank of California
Wachovia*
Washington Mutual

Support Team

The Risk Management Association
Operational Risk Advisors, LLC

Notes:

* AMAG Chair
** Steering Committee Member

AMAG Attachment:
Response Detail - NPR[1] and Supervisory Guidance

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[1] Joint Notice of Proposed Rulemaking (NPR)

Introductory Comment

The AMA Group remains supportive of the Advanced Measurement Approaches to estimating operational risk capital and agrees that banks should aspire to certain concepts (e.g. unit of measure) outlined in the NPR. The AMAG disagrees, however, with some of the proposed rules, particularly those that imply a level of precision that does not yet exist given the relative immaturity of the operational risk measurement discipline, and the relative paucity of loss data in a number of areas. Perhaps most importantly, the resultant specificity and prescriptiveness is contrary to the original spirit of AMA.

In our detailed response, which follows, the AMAG has highlighted several areas of concern in this regard including, but not limited to, Unit of Measure, Dependence and Expected Operational Loss. First, there is a notable lack of flexibility in the rules that would, in effect, disallow otherwise viable modeling approaches to determine Units of Measure. Second, the expectations laid out for the measurement of Dependence seem unrealistic. Third, the restrictions on allowable offsets for Expected Operational Losses are too narrowly defined. In combination these three issues have the potential effect of causing capital estimates to not be defensible by the members on an individual bank level. That would be a troubling and unintended outcome.

The Advanced Measurement Approaches were intended to allow for flexibility as banks develop internal models that most reflect their operational risks. A recent study completed by the AMAG confirms that a wide range of practices currently exists among banks subject to the rules. No consensus has yet developed on whether models should be "top down" or "bottom up". Regardless of the particular approach chosen, however, each bank has expressed confidence in the viability of its methodology. Adding restrictions and unrealistic expectations at this stage limits this flexibility and establishes a standard that may be beyond practical industry application at this early stage of model development.

1) Unit of Measure

a. NPR and Supervisory Guidance References

The NPR explicitly introduces and defines the concept of "unit of measure." The proposed rule defines a unit of measure as *"the level (for example, organizational unit or operational loss event type) at which the bank's operational risk quantification system generates a separate distribution of potential operational losses."* (Federal Register Vol. 71, No. 185, p. 55852; Supervisory Guidance p. 203)

The NPR goes further to say that, for a data grouping to be acceptable as a unit of measure for a specific loss distribution, a *"... bank must [also] demonstrate that it has not combined business activities or operational loss events with different risk profiles within the same loss distribution."* (Federal Register Vol. 71, No. 185, p. 55852)

The Supervisory Guidance includes Standard No. 27. This states: *"The bank must employ a unit of measure that is appropriate for the bank's range of business activities and the variety of operational loss events to which it is exposed, and that does not combine business activities or operational loss events with different risk profiles within the same loss distribution." (Supervisory Guidance p. 219)*

In the explanation that follows, the Supervisory Guidance goes on to say: *"Banks should weigh the advantages and disadvantages of estimating a single loss distribution or very few loss distributions (top-down approach), versus a larger number of loss distributions for specific event types and/or business lines (bottom-up approach). One advantage of the top-down approach is that data sufficiency is less likely to be a limiting factor, whereas with the bottom-up approach there may be pockets of missing or limited data. However, a loss severity distribution may be more difficult to specify with the top-down approach, as it is a statistical mixture of (potentially) heterogeneous business line and event type distributions." (Supervisory Guidance p. 219)*

"Supervisors will consider the conditions necessary for the validity of top-down approaches and evaluate whether these conditions are met in their particular individual circumstances." (Supervisory Guidance p. 219)

b. Discussion

In addition to our Introductory Comment on prescriptiveness and lack of flexibility, this NPR language and the language of Standard No. 27 itself are not consistent with the explanation that follows the Standard. The S.27 and NPR language preclude the use of top-down approaches because a loss distribution estimated on a firm-wide basis will certainly combine *" ... business activities or operational loss events with different risk profiles within the same loss distribution."*

The language following S.27, however, explicitly allows for top-down capital estimation approaches. It also goes from a single criterion – homogeneous risk profiles – to two criteria – homogeneity of risk profiles and data sufficiency.

The AMAG has recently inventoried its range of practices on capital estimation, and observed that its membership is largely divided between the use of bottom up and top down estimation methodologies. In light of the Supervisory Guidance clarifying text, it is the AMAG's belief that the agencies do not intend to preclude use of top down methods.

c. Suggestions

In view of the industry's range of practices at the present time, the AMAG believes that some clarification of the language in the proposed rule and the Supervisory Guidance would be important. The members are largely aligned in their thinking about this issue, and are in complete agreement on the specifics of suggestions for improving the language.

The AMAG proposes that one possible solution would be to leave much of the language intact, with the following exception. In the definition, the words: *distribution of potential operational losses* should be replaced with *measure for potential operational losses*. Otherwise, the proposed definition of unit of measure could be left intact.

In addition, contradictory language that currently appears in the text should be stricken. That is, delete:

> *"... bank must [also] demonstrate that it has not combined business activities or operational loss events with different risk profiles within the same loss distribution."* (Federal Register Vol. 71, No. 185, p. 55852)

Also, delete:

> *"...and that does not combine business activities or operational loss events with different risk profiles within the same loss distribution." (Supervisory Guidance p. 219)*

d. Implications

Our suggestion would achieve two things: (i) remove the ambiguity caused by the inconsistencies in the texts; (ii) provide clarity that both bottom-up and top-down capital estimation methodologies are permissible. As described above, this is a major concern for those institutions that are currently developing capital estimates at a high level, and employing allocation methodologies (i.e., hence the language *measure for potential operational losses* in the definition of unit of measure) to distribute the capital to lines of business or other units in the organization. Specifically, it is the current practice of several domestic U.S. institutions to calculate capital at the corporate level and allocate among their business entities (i.e., top down).

In addition, at least one Foreign Banking Organization (FBO) intends to allocate the results of its AMA capital, calculated at the Group level, to its U.S. DI and BHC subsidiaries. It will be impossible for the U.S. DI and BHC subsidiaries of an FBO to satisfy the use test of both the Basel II AMA as defined in the NPR, and the FBO's home country AMA at the same time. The NPR defines operational risk in ways different from

those of the Basel II Accord and the European CRD (Capital Requirement Directive). The reality will be that the U.S. subsidiaries will simply not be able to use both the operational risk estimates required by their home country approach and satisfy the U.S. NPR at the same time.

2) Dependence

a. NPR and Supervisory Guidance References

The NPR and Supervisory Guidance address the dependence or covariance between loss distributions. Dependence is defined in the NPR (p. 55913) and the Supervisory Guidance (p.202) as: "*...a measure of the association among operational losses across and within business lines and operational loss event types.*"

Both documents indicate that, where dependence assumptions are concerned (SG p 220), a "*...bank using internal estimates of dependence, whether explicit or embedded, must demonstrate that its process for estimating dependency is sound, robust to a variety of scenarios, and implemented with integrity, and allows for the uncertainty surrounding the estimates.*"

In support of this process requirement, the documents require additional conservatism in capital estimation. That is, a bank must demonstrate that it has explored dependence in some detail. Both the NPR and the Supervisory Guidance (in S.28) go on to argue that, in the absence of sound, robust estimates, developed with integrity and allowing for uncertainty, "*... the bank must sum operational risk exposure estimates across units of measure to calculate its operational risk exposure.*"

In the explanation that follows S.28, the Supervisory Guidance goes on to say: "*While dependence modeling for operational risk is an evolving area, banks should consider the following principles and guidelines:*

- "*Assumptions regarding dependence should be supported by empirical analysis (data) where possible. The Agencies expect this analysis will become more feasible over time as data availability increases and greater consensus emerges with regard to dependence modeling.*
- "*Where empirical support is not possible, dependence assumptions should be based on the judgment of business line experts. In such cases, it would be important to express dependence concepts in intuitive terms. ...*"

Later on, in the explanation, the Supervisory Guidance says that "*... top-down approaches inherently mask dependence and, under many circumstances, assume statistical independence across business lines and event types. To the extent a top-down approach is used, a bank should ensure that dependence within units of measure is suitably reflected in the operational risk exposure estimate.*"

b. Discussion

Although the proposed definition of dependence is adequate, the AMAG believes that it would be improved and less confusing if it related to units of measure rather than to business lines and operational loss event types.

In terms of application, the draft Rule and the supervisory guidance insist that a bank "must demonstrate" that its process of estimating dependency meets several criteria. As worded, this phrase results in an ambiguous requirement. At one extreme, "must demonstrate" could be construed to mean "prove statistically" which is a high and impractical general standard. At the other, it could mean "must describe" which seems peculiarly lax. Based on the explanatory text in the Supervisory Guidance, the better interpretation would seem to be that, if there is no empirical evidence, business judgment is fine. There is no explanation about the kinds of information or argument that should support these business judgments.

It would be excessively conservative to require a bank that cannot demonstrate the independence of risk exposures to sum operational risk exposures. It is highly unlikely that loss distributions across all units of measure are perfectly and positively dependent.

Finally, the AMAG takes issue with the statement that "*... top-down approaches inherently mask dependence and, under many circumstances, assume statistical independence across business lines and event types.*" This is not necessarily true. There is no inherent reason why a top-down approach has to mask dependence or assume statistical independence.

c. Suggestions

It would improve both texts to define dependence as "*... a measure of the association among operational losses across and within units of measure.*"

In addition, the AMAG believes that the following language should be stricken from the text:

> *"... the bank must sum operational risk exposure estimates across units of measure to calculate its operational risk exposure."*

The AMAG sees this as an important issue not simply for its unreasonable prescriptiveness and excessive conservatism. In addition, there is no such requirement about summing operational risk exposure included in either the Basel II Capital Accord or the European CRD.

The requirement to demonstrate that the process of estimating dependency meets appropriate criteria should be based on empirical evidence that is currently available,

whether it is statistical or anecdotal. Then the demonstration should be either based on established statistical techniques, more general mathematical approaches, or on clear logical argument regarding the presence or absence of relationships between the causes of different risks and losses, or regarding the similarity of circumstance between the bank and a peer group for which acceptable estimates of dependency are available. If no demonstration is forthcoming, then a conservative assumption of positive dependence is warranted, but not an assumption of perfect positive dependence (i.e., summing the exposure estimates).

Last, the AMAG believes that both drafts should delete any generalization regarding top-down approaches and the masking of dependence and assumption of statistical independence. If the regulatory agencies wish to express a preference that top-down approaches should not mask dependence and not assume independence, then it would be reasonable to say so.

d. Implications

Once again, the implications of our suggestions would be to make the proposed rule and guidance more reasonable and clear. Our suggested definition would add clarity. An improved description of what it means to demonstrate a degree of dependency would reduce ambiguity. A less extreme fallback assumption than 100% correlation would be more reasonable. Last, removing unfounded assumptions about top-down approaches would make both texts more defensible.

3. Expected Loss / Unexpected Loss (EOL / UOL)

a. NPR and Supervisory Guidance References

The proposed Rule defines EOL as *"...the expected value of the ... distribution of potential aggregate operational losses. The ANPR specified that a bank's risk based capital requirement for operational risk would be the sum of EOL and UOL unless the bank could demonstrate that an EOL offset would meet supervisory standards. The agencies described two approaches – reserving and budgeting – that might allow for some offset of EOL; however, the agencies expressed some reservation about both approaches. The agencies believe that reserves established for expected operational losses would likely not meet U.S. accounting standards and that budgeted funds might not be sufficiently capital-like to cover EOL."* (Federal Register Vol. 71, No. 185, p. 55900)

The text of the proposed Rule goes on to state that *"After further analysis and discussion with the industry, the agencies believe certain reserve and other internal business processes could qualify as an EOL offset. Under the proposed rule, a bank's risk-based capital requirement for operational risk may be based on UOL alone if the bank can demonstrate it has offset EOL with eligible operational risk offsets, which are defined as*

amounts (i) generated by internal business practices to absorb highly predictable and reasonably stable operational losses, including reserves calculated in a manner consistent with GAAP; and (ii) available to cover EOL with a high degree of certainty over a one-year horizon..." (Federal Register Vol. 71, No. 185, p. 55900)

In addition, the Supervisory Guidance, which was released in February 2007, goes on to state on p. 218 that *"the eligible operational risk offset process is intended to be flexible and dynamic in order to accommodate the continuing evolution of underlying business practices and accounting standards"*. Although it does not specifically exclude budgeting processes, it continues by stating that *"Supervisors will review all offsets to ensure that they are eligible as defined by the NPR"*.

b. Discussion

Reserves: Some AMAG members have expressed concern about the specifics of references to reserves. That is, it is possible that the expected loss calculation might be heavily influenced by legal reserves. At various points in time, legal reserves might well comprise a large portion of overall reserves and, as such, provide considerable contributions to the EOL offset.

The lack of specificity in the proposed rule and Supervisory Guidance makes it unclear, however, as to how a bank may use legal reserves, or alternatively if it might be penalized for misinterpretations or differences of opinion under Pillar II through capital add-ons. It is common practice in the industry to use legal reserves in economic capital calculations, but usage is not as clear for the regulatory capital calculation.

Budgets: The language in the proposed Rule is critical of using budgeted loss amounts as eligible offsets, but stops short of precluding them. The AMAG believes, however, that the process of budgeting in large AMA-eligible banks involves a degree of rigor that is, in fact, *"capital-like"*. By definition, if certain loss types can be budgeted, they are predictable, and therefore should qualify for offset.

In addition, it should be noted that such concerns regarding budgeting as a method to offset EOL are unique to the U.S. NPR, and are neither found in the Basel II Capital Accord, nor in the European CRD.

c. Suggestions

Reserves: On the subject of reserves, the definition should be modified such that those allowable for offset would include reserves that are more general in nature, but are set aside for relatively small, recurring, and predictable legal loss event types (i.e., legal reserves). An example of clarifying language would be to allow for "reserves that have a proven record of aligning to routine losses over a one-year time horizon".

Budgets: The AMAG suggests that budgets for loss events that also represent "highly predictable and reasonably stable operational losses" also be allowed for offset. Provided that they meet this test, the AMAG believes that budgeting should be added as an eligible offset for EOL.

d. Implications

The inclusion of legal reserves would better align practices relative to economic capital and regulatory capital estimates. In addition, the inclusion of predictable and reasonably stable budgeted losses would serve as another clarification of an eligible process, and the resultant rule would not be in conflict with the European CRD.

4. Disclosure

a. NPR and Supervisory Guidance References

On September 5, 2006, the agencies released a document separate from the proposed Rule itself entitled *Proposed Agency Information Collection Activities; Comment Request.* This text included on pp. 20-24, along with Schedule V, outlined information requests relative to Operational Risk.

The Supervisory Guidance released in February 2007 also included a similar scope of reporting requirements in Appendix D: Basel II Operational Risk Information Collection Templates (Schedule V), which requests reporting and disclosure of data for a set of 24 variables related to operational risk capital estimation.

The first 7 of these 24 Items are listed under a section entitled *Public*, and include questions about *Operational Risk Capital, EOL and Total Risk-based Capital Requirements* net of specified variables. Items 8 through 24 include questions about *Internal Operational Loss Data Characteristics, Scenario Analysis, Distributional Assumptions, and Loss Caps*, and are listed under the second section titled *Confidential.*

b. Discussion and Questions

General Comments**:** In order to respond fully on Schedule V, the AMAG requests more information about the specific subsidiaries to which these disclosure requirements would apply. Our comments below apply for disclosure at the consolidated parent entity level.

Specific Line Item Comments to Schedule V:

Items 1-2 The AMAG agrees that these items are appropriate for public disclosure.

Items 3-7 These items are valid requests from supervisors but should not be made public. The Public disclosure required by Schedule V far exceeds the public disclosure required by the Basel Accord. This additional public disclosure could put U.S. banks at a disadvantage to international banks, which will follow the less onerous disclosure requirements of the Basel Accord.

In addition, the level of disclosure of additional supporting material to the public that would be needed for a reader to understand these lines would go well beyond what is appropriate. Without this additional material, the users of the public information would not be able to make valid comparisons of these line items across institutions. What is more, these disclosures would potentially involve data that is sensitive from a competitive perspective, e.g., EOL.

Item 8 It is unclear to the AMAG as to which starting and ending dates are required in the event that these dates differ for frequency and severity estimation.

Item 9 The AMAG requests clarification of the requirements for this item. Some banks use different thresholds for different purposes including data collection, reporting, and multiple elements of the modeling framework. These thresholds can then vary by other criteria, e.g., major sector.

Items 11-15 The AMAG requests clarification as to whether this question relates to losses captured as individual events, above certain thresholds. Institutions also capture the dollar amount of some smaller losses, below our thresholds, in the aggregate, and without capturing the number of individual events.

Items 16-18 Given diverse approaches to scenario analysis within the industry, the AMAG would like to confirm that these requirements refer to the number scenarios as defined by the different approaches and do not imply that one specific approach is now being required.

Items 20-21 It is unclear to the AMAG whether the change refers to a change in parameter of a distribution or a change in distribution class.

Items 23-24 The AMAG requests confirmation that if a bank does not use loss caps, then it will be acceptable to respond to these Items with 'not applicable' (i.e., the schedule requests a numerical value).

c. Suggestions

The AMAG requests clarification of instructions for completing Schedule V, and / or changes as described above.

Items 3-7 in the Public Disclosure section should be moved to the section entitled *Confidential*. Under current industry practices, these items are not publicly disclosed.

d. Implications

The AMAG does not envision any negative implications of revising the disclosure, as described above, particularly relative to Items 3-7. The industry and agencies should convene to discuss or correspond relative to the implications of responses to our other questions, as noted above.

5. Reservation of Authority

a. NPR Reference

The draft NPR proposes that regulatory agencies should reserve the authority to prescribe specific parameters and other input variables and techniques for the calculation of operational risk capital.

Specifically, the proposed rule states "*it would provide authority for a bank's primary Federal supervisor to require the bank to assign a different risk-weighted asset amount for operational risk, to change elements of its operational risk analytical framework (including distributional and dependence assumptions), or to make other changes to the bank's operational risk processes, data and assessment systems, or quantification system if the supervisor find that the risk-weighted asset amount for operational risk produced by the bank under the rule is not commensurate with the operational risks of the bank.*" (Federal Register Vol. 71, No. 185, p. 55842)

b. Discussion

As drafted, the Reservation of Authority language implies a degree of prescription that is counter to the principles-based intent of the AMA. The AMAG is strongly opposed to the approach outlined in this section on the belief that:

1) It is inappropriate as it is directly contrary to the spirit and principles of the Advanced Measurement Approaches. In essence, the rule has the effect of removing discretion from the AMA banks.

2) It will reduce the level of analytics and innovation currently devoted to the measurement of operational risk substantially. Further beneficial development in this emerging discipline will likely stagnate.

3) It is impractical insofar as under such an approach parameters and input variables governing operational risk capital calibration would need to be monitored, tested and possibly adjusted on a regular, even quarterly, basis for all AMA institutions. We do not believe this is a workable or desirable scenario for the regulatory authorities.

c. Suggestions

Remedies already exist under Pillar 2 to address situations where capital requirements are believed to be understated. As such, the AMAG recommends striking this language from the rule and addressing the Agencies' concerns under Pillar 2.

NPR Questions

Question 19:

a. NPR Reference

"Question 19: The Agencies solicit comment on all aspects of the proposed treatment of operational loss and, in particular, on (i) the appropriateness of the proposed definition of operational loss; (ii) whether the Agencies should define operational loss in terms of the effect an operational loss event has on the bank's regulatory capital or should consider a broader definition based on economic capital concepts; and (iii) how the Agencies should address the potential double-counting issue for premises and other fixed assets." (Federal Register Vol. 71, No. 185, p. 55851)

Q.19 Definition part (i) – Operational Loss

a. NPR Reference

The proposed rule defines operational loss as *"a loss (excluding insurance or tax effects) resulting from an operational loss event. Operational losses include all expenses associated with an operational loss event except for opportunity costs, forgone revenue, and costs related to risk management and control enhancements implemented to prevent future operational losses."* (Federal Register Vol. 71, No. 185, p. 55851)

"Operational loss event means an event that results in loss and is associated with internal fraud; external fraud; employment practices and workplace safety; clients, products, and business practices; damage to physical assets; business disruption and system failures; or execution, delivery, and process management." (Federal Register Vol. 71, No. 185, p. 55851)

b. Discussion

Generally speaking, the AMAG concurs with the proposed definition of operational loss. The definition is consistent with industry practice. Some members note that there is value in benchmarking operational losses and risk capital with other financial institutions, as well as trending internal loss event data and operational risk capital by event types over time. The proposed definition would be appropriate, therefore, and would enable such benchmarking.

The Basel II Capital Accord and the European CRD, however, do not contain a formal definition of "operational loss". Under each of these standards, internal loss data must be mapped against and dictated by the loss event types.

c. Suggestions

As such, to the extent that a definition is necessary, the proposed wording is acceptable to most AMAG members. Some request, however, that the NPR NOT include a prescriptive definition of "operational loss". To do so may introduce additional inconsistencies between U.S. rules relative to the Basel II Capital Accord and the European CRD.

In addition, the Basel II Capital Accord and the European CRD allow institutions to implement AMA initially with only three years of historical loss data.[2] In contrast, the Basel II NPR has proposed that *"a bank's operational risk data and assessment system must include a minimum historical observation period of five years of internal operational losses"*[3].

[2] Basel II Capital Accord, paragraph 672; Directive 2006/48/EC, Annex X, Part 3, Section 1.2.2

[3] Basel II NPR, Section III Qualification.

Some AMAG members suggest that the Basel II NPR minimum historical observation period proposal be brought into line with the Basel II Capital Accord and the European CRD, for institutions' initial implementation of AMA.

Q. 19 Definition part (ii) – Regulatory capital

a. NPR Reference

"(ii) Should the Agencies define operational loss in terms of the effect an operational loss event had on the bank's regulatory capital or should [the Agencies] *consider a broader definition based on economic capital concepts?"* (Federal Register Vol. 71, No. 185, p. 55851)

b. Discussion

The AMAG generally believes that the definition should remain tied to direct financial effects on banks' regulatory capital over a one-year time horizon. A pure economic view of the total loss, e.g., including opportunity costs and foregone revenues, while potentially useful in some cases for management purposes, is not the relevant view for regulatory capital purposes and goes beyond the financial effects that capital should bear.

The immediate impact to capital of any damage is based on the book carrying value. The other equally important economic and reputational impacts should be managed through appropriate risk management processes, including risk control and risk mitigation. For example, in the case of premises, the potential to lose the full economic value of the premises, which may include lost revenue in addition to the replacement value of the premises, can be adequately covered by insurance.

Although the AMAG supports the use of economic capital concepts, and agrees with efforts made to bring Basel II regulatory capital in line with economic capital methodologies, in this case the AMAG believes it would confuse the issue unnecessarily. Operational risk economic capital is not a well-developed discipline. To use it as the basis for Basel II regulatory capital could easily lead to a situation in which methods evolve and regulatory capital is forced to change or be out of step with emerging practices.

c. Suggestions

The AMAG suggests continuing with the current NPR approach of basing regulatory capital of the potential loss reflected directly in the financial statements over a one-year time horizon.

Q.19 Definition part (iii) – Premises and Other Fixed Assets

a. NPR Reference

"(iii) How the Agencies should address the potential double-counting issue for premises and other fixed assets." (Federal Register Vol. 71, No. 185, p. 55851)

b. Discussion

The proposed rule requires that bank premises be assigned a risk-weighted asset value equal to the carrying value of the premises, and also requires that operational risk capital reflect losses associated with damage to physical assets. As such, the AMAG agrees that the rule results in double counting. Loss associated with damage to physical assets are treated as all other operational losses within the operational risk capital model and, to the extent that the model has been validated, accurately captures the operational risk exposure associated with owning bank premises. Including the risk associated with owning premises within the operational risk model is a more accurate determination of the amount of capital that is required to support these assets than the crude risk-weighted asset approach.

The AMAG believes that the regulatory proposal to compute capital for fixed assets is flawed in two respects. First, the proposal creates a capital charge for "risk-weighted asset amounts for assets that are not included in an exposure category". Second, the proposal suggests that additional capital may be required because the carrying value of such assets on the balance sheet can be substantially less than market or replacement value. The AMAG strongly believes that such a capital charge is unnecessary and inappropriate inasmuch as:

1) The potential loss associated with such assets and the requisite level of capital for such risk is indeed already captured along with other operational risks within the LDA approach under the risk category of "Damage to Physical Assets". Historical losses, both internal and external, are tracked and monitored similar to all other operational risk categories. The risk associated with Fixed Assets can be analyzed within scenario analysis exercises and capital requirements for these risks are included in any computation of overall operational risk capital.

2) The existing Basel I approach to capital for Fixed Assets is not risk-based, it grossly overstates the level of capital required and is not supported whatsoever by the historical losses associated with such assets.

In addition, the concept of holding incremental capital for the difference between market or replacement value, and the book or carrying value of Fixed Assets is asymmetrical and also flawed. First, no capital credit is given for the under-

valued nature of these assets. Second, the logic that holding under-valued assets on the balance sheet implies the need for additional regulatory capital would imply that holding 'over-valued' assets would indeed free up capital.

c. Suggestion

In order to avoid double counting, the additional capital requirement associated with the risk-weighted asset approach to bank premises should be removed. That is, eliminate the calculation of capital based on risk-weighted assets under section 31(e)(3) of the proposed rule. The risk of loss from damage to physical assets should be included only in Operational Risk Capital.

We understand that one option might be to instruct that premises and certain other fixed assets should be capitalized based on a separate schedule, then an explicit exclusion of these risks from operational risk could be included in the rules. The AMAG does not support this approach, because, even though it would eliminate double counting, it would lead to an unnecessary gap between internal economic risk capital and regulatory capital principles.

NPR Question 27 Boundary between Credit and Operational Risk

a. NPR Reference

"Question 27: The Agencies seek commenters' perspectives on other loss types for which the boundary between credit and operational risk should be evaluated further (for example, with respect to losses on HELOCs)" (Federal Register Vol. 71, No. 185, p. 55861)

b. Discussion and Questions

The AMAG believes that additional discussion would be needed on this issue and evaluation of numerous illustrations considered beyond the single example cited in the NPR:

Illustrative Question: If an operational error causes an unexpected (and unwanted) credit exposure that subsequently results in a loss, would the resultant loss be classified as an operational loss event or a credit loss event?

Example: A client's account is credited by mistake. Upon discovery of the error a claim is made for the return of the funds plus compensation. The client is unable to return the funds due to liquidity problems. A demand loan is created and penalty interest is applied. A default occurs.

Some AMAG members' tendency has been to treat these as credit losses given the availability of "excess" loan loss reserves, regardless of the causal effect.

This is but one of many examples that would need to be vetted fully.

c. Suggestions

The definition of the boundary between credit and operational risk is a topic of such importance that a thorough dialogue among international regulators is absolutely necessary before a change to the U.S. rules is contemplated. Those elements, which are a fundamental component of the Basel Accord, were developed in consultation sessions with the industry and among regulators for several years. A unilateral revision of such elements by an individual Basel Committee member country could possibly not only jeopardize the international character of the Accord, but also create greater regulatory inconsistencies across jurisdictions, an outcome that both industry and regulators should endeavor to prevent. The AMAG does not recommend evaluating further other areas involving the boundary between credit and operational risk in the context of the NPR.

Question 28 Boundary Between Credit, Market and Operational Risk

a. NPR Reference

"Question 28: The Agencies generally seek comment on the proposed treatment of the boundaries between credit, operational, and market risk." (Federal Register Vol. 71, No. 185, p. 55861)

b. Discussion

Treating losses, such as those incurred from a failure of bank personnel to properly execute a stop loss order, from trading fraud, or from a bank selling a security when a purchase was intended, as operational risk losses is consistent with industry practice.

The AMAG notes, however, that some challenges have yet to be overcome relative to "embedded operational risk losses" (e.g., Foreign Exchange ("FX")). Example: A trade

is entered with the incorrect exchange rate. The reconciliation process discovers the error and an off-setting trade is entered the next day. If there is a "net" loss as a result of the latter, it is included in the trader's P&L. Members are at different stages of development in tracking these occurrences and considering them to be operational losses, not trading losses.

c. Suggestions

The AMAG supports treating operational losses (e.g., errors, fraud) that are related to market risk as operational losses for purposes of calculating risk-based capital requirements.

Consistent with our response to Question 27, however, the definition of the boundaries between credit, market and operational risk, is a topic of such importance that a thorough dialogue among international regulators, in consultation with the industry, is absolutely necessary before a change to the U.S. rule is contemplated. The AMAG does not recommend evaluating further other areas involving the boundary between credit, market and operational risk in the context of the NPR.

Question 60 – Predictable Losses

a. NPR Reference

"Question 60: The Agencies are interested in commenters' views on other business lines or event types in which highly predictable, routine losses have been observed." (Federal Register Vol. 71, No. 185, p. 55900)

b. Discussion

The industry has identified fraud losses associated with debit and ATM cards, in addition to securities processing and credit card fraud, as operational risk losses, which should qualify as highly predicable, and where routine losses should qualify for the expected operational risk loss offset.

Furthermore, the proposed rule asserts that *"supervisory recognition of EOL offsets will be limited to those business lines and event types with highly predictable, routine losses. Based on discussions with the industry and empirical data, highly predictable and routine losses appear to be limited to those relating to securities processing and to credit card fraud."* The Basel II NPR seeks respondents views *"on other business lines or*

event types in which highly predictable, routine losses have been observed".[4] [Emphasis added]

c. Suggestions

The AMAG believes that the proposed rule gives a rather limited perspective on what losses could be defined as highly predictable and routine and, therefore, allowed to offset EOL. From the point of view of large, complex banking institutions with sophisticated risk management processes, predictable losses could encompass all business lines and event types and, therefore, the loss event types considered predictable in the proposed rule should not be restrictive.

Please also refer to the AMAG's Suggestions in response to the topic of EOL/UOL and EOL offsets on pp. 7-9 of this text.

[4] Basel II NPR, Part VI, Operational Risk