

January 12, 2024

Via electronic submission & E-Mail

Chief Counsel's Office  
Attention: Comment Processing  
Office of the Comptroller of the Currency  
400 7<sup>th</sup> Street SW  
Washington, DC 20219

Ann E. Misback, Secretary  
Board of Governors of the Federal Reserve System  
20<sup>th</sup> Street and Constitution Avenue NW  
Washington, DC 20551

James P. Sheesley,  
Assistant Executive Secretary  
Attention: Comments/Legal OES (RIN 3064-AF29)  
Federal Deposit Insurance Corporation  
550 17<sup>th</sup> Street NW  
Washington, DC 20429

Re: Regulatory Capital Rule: Amendments Applicable to Large Banking Organizations and to Banking Organizations with Significant Trading Activity (OCC: Docket ID OCC-2023-008; FRB Docket No. R-1813, RIN 7100-AG64; FDIC RIN-3064-AF29) (the “NPR” or “Proposed Rule”)

## **I. Background**

We appreciate the opportunity to provide our comments regarding the above-referenced NPR. This letter is submitted by the Advanced Operational Risk Group (“AORG”) of The Risk Management Association (“RMA”), a 501(c)(6) not-for-profit corporation.

RMA is a 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 principles to improve institutional performance and financial stability, and enhance the risk competency of individuals through information, education, peer-sharing, and networking. RMA has approximately 1,000 institutional members, including banks of all sizes as well as nonbank financial institutions.

One of the most important components of RMA’s mission is to provide independent analysis on matters pertaining to risk and capital regulation. In this regard, the comments contained herein are informed by subject matter experts from member institutions of the RMA AORG. The AORG was formed in 2005 as the AMA Group by RMA at the suggestion of senior U.S. regulators.

AORG’s mission is to conduct regular practice-sharing exercises among members and pursue an ongoing industry-regulatory dialogue toward the advancement of operational risk management. In fulfilling its mission, AORG sponsors a series of working groups, periodic range-of-practice surveys,

and roundtable discussions. AORG consists of operational risk management professionals working at financial service organizations operating in the United States. Institutional membership in AORG is by arrangement with RMA and is open to any financial firm regulated in the U.S. that is pursuing advanced operational risk measurement and management practices, and/or is required to conduct CCAR/DFAST exercises. A senior officer responsible for operational risk management serves as the primary representative of each member institution to AORG.

Since its inception, AORG has supported advanced operational risk management and the fundamental goals of improving operational risk management practice and ensuring capital adequacy. To achieve these goals AORG has promoted the view that regulatory agencies must address the following two broad themes as they continue to move from policy development to supervisory and examination practice: (i) operational risk regulation should remain principles-based vs. prescriptive in nature, and (ii) a proper balance between management and measurement should be maintained.

The members of the AORG are listed in Exhibit A. 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 AORG member institutions.

## **II. Overview**

### **Core Principles**

In the context of the NPR, AORG broadly favors a principles-based approach, risk-sensitivity, and flexibility to reflect unique differences across AORG member firms (including with respect to scale, diversity, business mix, complexity, and loss absorption capacity), simplicity, comparability across firms within the U.S., and a level playing field globally. We recognize that elements of standardization inherent in the proposed Basel III Endgame approach do limit the ability to fully realize, simultaneously, some of the objectives listed above. However, these objectives will guide our comments as much as possible.

Many of the AORG key comments are aligned further below with the specific questions that are embedded in the NPR. We are also providing additional comments and requests for clarification that are not aligned specifically with the embedded questions.

### **Overarching Points**

A few overarching points can be seen across the comments below.

We believe that the overall framework in the proposed rule with respect to operational risk exhibits excess conservatism which collectively might overcapitalize operational risk and drive unintended, undesired consequences for the U.S.-regulated banking industry and its customers, including a reduction in competitiveness globally. The Internal Loss Multiplier ("ILM") floor eliminates a potential favorable reward for institutions that have lower losses compared to others of the same size. Another example is the capitalization of non-economic, accounting-error, timing events. Further, the Stress Capital Buffer ("SCB") was originally calibrated using the current standardized pillar which implicitly incorporates operational risk in its conservatism on market and credit risk. Now, the SCB is applied to the Expanded Risk Based Approach ("ERBA") which includes operational risk capital

explicitly without re-calibrating the SCB or the proposed approach for operational risk for this additional capital requirement.

AORG wishes to see significant alignment of the U.S. rules with Basel Guidance and instead sees areas of divergence.

AORG recommends that requirements to capture new data elements should, in most cases, be implemented prospectively versus retroactively, and where retroactive requirements may apply, they should be applied only at substantially higher thresholds for significance than seen in the NPR. (Examples include timing losses and loss events related to mergers/acquisitions.)

Where the existing definitions of operational risk, loss, and categories are being changed, we would like to see the changes identified more explicitly, and we would like to have clear guidance on which of those changes need to be made retroactively and for which historical time periods. For example, the reference in the definition of operational risk losses to “restatements or corrections of financial statements” is new and not clear enough. Specifically, it is not clear whether the reference to restatements or corrections of financial statements is intended to be distinguishing correcting entries made in the current reporting period financials from those correcting entries made currently to change a prior period’s financials. It is also not clear which filing and financial statements are in scope, SEC filings (some or all), regulatory filings (some or all), or both. Additionally, the proposed rule attempts to clarify the definition of timing losses, and we believe additional detail is needed for clarity in this area.

Substantially higher thresholds than \$20,000 should apply to a number of data elements, and the term “material” should be replaced as it is at odds with the longstanding use of that word in the context of published financial statements. An alternative term might be “recordable.” Areas where a higher threshold should apply include, but are not limited to, timing losses, loss events related to mergers/acquisitions, details such as specific dates within a quarter on legal accruals, and further details on operational risk events.

The industry needs more clarification on the interplay of and consistency across the rules, definitions, and requirements spanning multiple related, but distinct, regulatory elements, such as (but not limited to) Basel III, CCAR/DFAST, FR Y-14Q, call reports, the tailoring rule, and regulatory disclosure requirements. For example, it needs to be clarified whether the FR Y-14Q will continue to require loss data from all available periods, as opposed to the 10 years of data required under the NPR, and more clarity is needed about how changes in definitions for Basel III in the final rules will apply to historical data that is used or reported under other existing regulatory requirements.

More clarity is also needed about the lag for reporting and use of operational risk loss data under the NPR. The lag should be 90 days (one-quarter) to allow time for ensuring quality, and flexibility is needed for firms to ensure that data is not required to be used before its quality is adequate.

The costs of the new requirements for banks not previously calculating AMA capital may foster or discourage bank consolidation in ways the regulators and bank constituents might not find favorable.

### III. Responses to NPR's Embedded Questions

**Question 74:** *What are the advantages and disadvantages of the proposed approach to calculating the services component, including any impacts on specific business models? Which alternatives, if any, should the agencies consider and why? Similarly, should the agencies consider any adjustments or limits related to specific business lines, such as underwriting, wealth management, or custody, or to specific fee types, such as interchange fees, and if so what adjustment or limits should they consider? For example, should the agencies consider adjusting or limiting how the services component contributes to the business indicator and, if so, how? What would be the advantages and disadvantages of any alternative approach and what impact would such an alternative approach have on operational risk capital requirements? For example, under the proposal, fee income and expenses of charge cards are included under the services component. Would it be more appropriate for fee income and expenses of charge cards to be included in net interest income of the interest, lease, and dividend component (and excluded from the services component) and for charge card exposures to be included in interest-earning assets of the interest, lease, and dividend component and why? Please provide supporting data with your response.*

#### Disadvantages

The proposed rule to calculate the business indicator appears to be motivated by the following statement: “Given that operational risk is inherent in all banking products, activities, processes, and systems, these components aim to capture comprehensively the volume of a banking organization’s financial activities and thus serve as a proxy for a banking organization’s business volume. Banking organizations with higher overall business volume are larger and more complex, which likely results in exposure to higher operational risk. Higher business volumes present more opportunities for operational risk to manifest. In addition, the complexities associated with a higher business volume can give rise to gaps or other deficiencies in internal controls that result in operational losses. Therefore, higher overall business volume would correlate with higher operational risk capital requirements under the proposal.”<sup>1</sup>

The correlation between business volume and operational losses is a generalization that is not necessarily experienced by all banks. This one-size-fits-all set of factors does not differentiate economic risk of different lines of business (“LOBs”) with predominantly fee-based revenue. As a result, the rules may disadvantage certain lower-risk, fee-based businesses and drive unintended consequences for individual banks, customers, and the playing field for U.S.-regulated banks versus global banks and nonbanks. The adoption of the calculation of the services component would result in higher capital for non-interest and fee-based business activity, and those banks with a large share in these products and services are adversely impacted, creating disparate treatment among the industry. To the extent that the operational risk capital for fee-based businesses is excessive for its risk, capacity to provide such services may be limited and some activities may move outside of the banking industry, possibly increasing pockets of systemic risk that sit outside of the scope and view of bank regulators. Inconsistency with other jurisdictions might create a competitive disadvantage between U.S.-regulated banks and institutions in other jurisdictions with the consequence of pushing some global banking risk out from under the direct supervision of the U.S. regulators.

Specifically, for some institutions with predominantly fee-based revenue, the proposed calculation of the services component leads to a business indicator component that is meaningfully larger than the

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<sup>1</sup> See pages 187-188 of 1087 in the interagency document released on 7/27/2023.

loss component, which in turn results in an internal loss multiplier below 1. Those institutions would be affected by the proposed flooring of the ILM to 1 (see below for additional comments on the ILM floor). Moreover, as the growth rate of the business indicator component for some of those institutions tends to be larger than the growth rate of the loss component, operational risk-weighted assets would grow perpetually with the growth rate of the business indicator component. In the end, the growth rate of the fee-based revenue drives the growth rate of operational risk-weighted assets directly, because there is no mechanism in the calculation of the services component that would limit this growth.

The Interest, Lease, and Dividend Component is calculated as the absolute value of the difference between total interest income and total interest expense and subject to a ceiling equal to 2.25% of a banking organization's total interest-earning assets. In contrast, the services component is calculated as a gross amount (higher of income or expense) and is uncapped. The proposed gross amount calculation and uncapped sum of services component operational risk capital disproportionately impacts banks predominantly engaged in fee-based activities. Many of these activities have observably lower historical losses than non-fee-based activities and generate stable fee income even in periods of economic stress.

In the consultation phase before the finalization of the Basel Reforms in 2017, discussions took place to add a limiting principle to the share of the services component within the business indicator component. Compared to the global context, institutions with predominantly fee-based revenue are significantly more important for the U.S. financial services sector, and the disparate treatment of such institutions results in misaligned incentives and unintended consequences for operational risk-weighted assets. Therefore, AORG recommends that the calculation of the business indicator component be finalized such that the services component amounts to no more than a percentage, to be specified in the final rule, of the business indicator component. The AORG recognizes that the regulators likely will rely on empirical work to establish this percentage, which many AORG members suggest should be at or below 50%.

### **Advantages**

The only possible advantage seen by AORG is simplicity, but this is viewed as insignificant relative to the disadvantages.

### **Alternatives**

Instead of a simple summation of the components of the business indicator, which would not capture differences in risks between each component, we recommend the Agencies limit the share of the services component of the total business indicator amount. Implementing such a limit would be similar to the approach taken by the Federal Reserve in implementing the capital surcharge for global systemically important banks (the GSIB Surcharge).

Another approach could entail establishing different capital rates for different revenue streams, based on risk. While effective, this approach would have the disadvantage of a more complex calculation that would need a sound empirical basis to establish differentiated rates.

In the context of mentioned alternatives, we request clarification of the definition of a “charge card.”

**Question 75:** *What are the advantages and disadvantages of flooring the internal loss multiplier at one? Which alternatives, if any, should the agencies consider and why?*

**Question 76:** *What are the advantages and disadvantages of including the internal loss multiplier as opposed to setting it equal to one?*

AORG's core principles include a principles-based approach, risk-sensitivity, flexibility to reflect unique differences across our member firms (including with respect to scale, diversity, business mix, complexity, and loss absorption capacity), simplicity, comparability across firms within the U.S., and a level playing field globally.

On this basis, AORG strongly opposes the current proposal of an ILM with a floor at one. Some AORG members favor a floating ILM, while others prefer an ILM fixed at one, however, the AORG members are in broad agreement that either alternative is preferable to the current proposal in the NPR of an ILM with a floor of one.

## ILM with a Floor of One

### Disadvantages of a Floor of One

The floor undermines the risk-based principle behind the Bank for International Settlements (“BIS”) Basel Committee on Banking Supervision (“BCBS”) Basel III guidance, as the ILM only comes into play in a selective manner, when it is punitive, and does not reward banks that manage their operational losses down to a level generating an ILM below one. Allowing the ILM to reflect the level of a financial institution's operational risk losses relative to the size of its business activities, regardless of whether that reduces or increases core operational risk capital, aligns with the risk-based principles underlying Basel III. In addition, the floor is inconsistent with the BCBS Basel III final guidance that provides for the option to set the ILM equal to one, but does not contemplate a floor. Further:

- The approach does not reward better operational risk management practices, as financial institutions that would manage their activities in a way that results in a lower operational risk profile (and resulting operational losses) relative to the size of their business activities, would not receive sufficient capital benefit through the ILM, as the ILM would not be allowed to drop below one. Flooring the ILM at one removes one lever to reward financial institutions to enhance and strengthen their risk management practices, as having a lower risk profile (and resulting losses) would not lead to further reductions in their operational risk capital. It is critical that the U.S. regulators use opportunities to further reward strong operational risk management practices, as this can lead more financial institutions to enhance their operational risk profile.
- Flooring the ILM at one implies that historical losses are predictive only in one direction, which is not supported by empirical data and appears to be introduced only to add conservativeness to the operational risk calculation, without any clear risk-based benefit. Furthermore, not all AORG members agree that high historical losses are necessarily a valid predictor of elevated prospective operational risk levels.
- There is no significant precedent for flooring the ILM at one in any jurisdiction that has already implemented Basel III (e.g., Canada and Australia) or in any jurisdiction currently in the process

of implementing Basel III (e.g., United Kingdom & Europe). As such, flooring the ILM at one would put U.S. financial institutions at a disadvantage, relative to foreign financial institutions, as such institutions would not be burdened by such a one-sided excessively conservative convention.

- Flooring the ILM at one makes the U.S. Basel III formula less comparable to other jurisdictions, as it will effectively be a rule unique to the U.S. This introduces more variability into how operational risk capital/RWA is calculated across jurisdictions and further limits industry consistency and comparability, which is one of the goals behind the introduction of Basel III reforms globally.
- The approach is similar to the starting point under the treatment for a financial institution that does not have at least five years of operational loss data meeting quality standards. There is no significant incentive for a firm to ensure they have 5 to 10 years of loss data meeting quality standards, if, as a starting point, their ILM would end up being set to one either way.

### **Advantages of a Floor of One**

AORG members have considered whether there are any potential advantages to flooring the ILM at one; no significant advantages have been identified. The increase in operational risk capital is not seen as an advantage, given the uneven global playing field it would create for financial institutions subject to the U.S. rules, and the potential for a negative impact of the U.S. rules on the health of the financial services firms subject to its impact.

### **Alternatives to a Floor of One**

AORG considered two specific alternatives to the floored ILM, a floating ILM, and an ILM set to one. There is a range of perspectives among the AORG membership reflecting a range in business models and size of the member institutions.

### **Floating ILM - Advantages**

- Allowing the ILM to vary symmetrically according to the proposed formula without the floor makes the Basel III Endgame approach to determining operational risk capital more variable, and more “risk-sensitive” to the extent that historical losses are predictive of increased risk of future losses. Under this assumption, the ILM will reflect the risk profile (and level of potential future operational risk losses) of the financial institution, relative to their size, as measured by the Business Indicator Component (“BIC”); this aligns with the risk-based principle behind the BIS BCBS Basel III guidance.
- Allowing the ILM to vary symmetrically rewards the right type of operational risk management practices as financial institutions will have further reasons to continue enhancing/strengthening their risk management practices, as a lower risk profile (and resulting losses) leads to a lower ILM which reduces their operational risk capital requirements.
- A floating ILM is consistent with the Canadian approach where the ILM is allowed to fluctuate based on a financial institution's operational risk losses, relative to their size, as measured by the BIC. This allows for greater comparability with financial institutions operating in a jurisdiction that is geographically close to the U.S.

## ILM Set to One - Advantages

- Setting the ILM to one simplifies the Basel III approach as no historical loss data needs to be incorporated. Offsetting this advantage is the continued requirement for operational risk loss collection and reporting for firms subject to FR Y-14Q reporting.
- Setting the ILM to one would be more cost-efficient to the industry overall as it would remove the work needed to accurately incorporate operational losses within the capital calculation, and would also remove the need to expand resources on validating that all firms are applying the rule consistently (less supervisory resource needed on this). The proposed updates to the definition of operational losses that were specifically motivated by the capital calculation approach would no longer be necessary, in particular the proposed changes to the definition of timing losses.
- Setting the ILM to one may be more risk-appropriate, as a financial institution's historical losses are not necessarily indicative of its future risk of loss, as institutions that have incurred large losses may take significant corrective actions after experiencing the loss. Historically, the largest operational risk losses have been incurred because of litigation and/or regulatory investigation, due to inappropriate business practice. Institutions may react to these losses by implementing new and more robust controls and/or by making a business decision to stop participating in the business that generated those losses.
- Increases comparability across firms within this jurisdiction by removing potential differences related to the collection of loss events and calculation of the average annual loss.
- Although less variable, setting the ILM at one is not necessarily significantly less risk-sensitive. The variability of the floating ILM is not necessarily reflective of prospective risk levels because some members do not agree that historical losses are for all firms valid predictors of future loss levels.
- Increases comparability with some jurisdictions including Australia where the ILM is set to one and would serve as a supporting precedent, potentially, for the UK and Europe which have indicated their intention to set the ILM to one.
- Does not rely on historical losses which have not been proven to be a valid predictor of future operational risk in all cases. Often firms with major operational risk losses make changes in their risk and control environment to mitigate the risk of similar losses occurring in the future. In addition, firms that are acquired and have a history of outsized operational risk losses will often become subject to an improved control environment of the acquiring entity. This behavior reflects sound operational risk management; however, it may reduce the assumed predictive characteristics of the historical loss data in such cases.
- Financial institutions that have experienced significant losses relative to their size as measured by the BIC would not be required to hold additional capital for the ILM long after improvements in the risk and control environment have been implemented. Significant losses will be incorporated into their Loss Component for ten years.

**Question 77:** *What are the advantages and disadvantages of the treatment proposed for losses of merged or acquired businesses? Which alternatives, if any, should the agencies consider and why? What impact would any alternatives have on the conservatism of the proposal?*

## Disadvantages

The proposal as written is inconsistent with the Basel rule (and other jurisdictions' implementation of the rule) which does not require estimating historical losses for acquisitions to the extent seen in the

NPR, and imposes a material operational burden and a potential competitive disadvantage on banks operating in the U.S.

Because the rule is not specific to the type or size of merged or acquired entities, historical operational losses would have to be estimated for small, non-financial acquisitions that have de minimis historical losses.

In addition, the estimation calculation assumes that the BI components can be easily generated from consolidated financial metrics both with and without the acquired entity's contribution. To do this at the time of acquisition is only feasible for financial institutions that already publish call reports (FR Y-9C); to do this after acquisition (at the time of initial consolidated financial reporting) will be operationally impractical.

### Alternatives

An appropriate threshold for the size of an acquired entity should be specified, e.g. depository institutions that publish a Call Report (FR Y-9C) or nonbank financial institutions ("FIs") with revenues greater than (a specified figure) for a significant percent of the acquiring entity, as these are likely to have historical losses that might impact average historical losses and therefore the ILM.

Acquisitions of assets and portfolios (e.g., credit cards) should be excluded as the acquisitions are not of a legal entity, and the firm is not integrating a company's business operations into its own business operations. Post-acquisition operational losses from the management of those assets or portfolios will be included as a routine matter.

Most financial institutions already have standards in place for collection of historical losses for acquisitions. The estimation of historical losses should be redefined to:

- use average quarterly loss data provided by the acquired entity to estimate any missing historical quarters;
- use Revenue for non-depository FIs rather than BI as a proxy where no historical loss data is available;
- require a shorter historical back-fill period (3 rather than 10 years); and
- apply the rule to acquisitions going forward from the SMA "go-live" date rather than retroactively.

**Question 78:** *What are the advantages and disadvantages of an alternative threshold for the operational losses for which banking organizations may request supervisory approval to exclude?*

### Advantages

An alternative to the proposed threshold of 5% of average annual total net operational loss could be a threshold that is proportional to and more appropriate for the firm's characteristics. This would increase relative consistency.

Alternative thresholds could enable banks to distinguish by event category in a way that is more appropriate for the level of risk. For example, higher thresholds are appropriate for those accounting timing losses that are not economic, full-cycle, including those for which no money has

or does move in or out of the firm, and for loss history for certain types of mergers (e.g., small, non-FI).

### Disadvantages

An alternative threshold than the 5% of average annual total net operational loss would create inconsistency across firms on a simple numerical basis (not on a proportional basis).

**Question 79:** *The proposal would require a banking organization to collect information on the drivers of operational loss events, with the level of detail of any descriptive information commensurate with the size of the gross loss amount. What are the advantages and disadvantages of this requirement? Which alternatives should the agencies consider - for example, introducing a higher dollar threshold for such a requirement – and why?*

### Advantages

Firms already have loss event collection processes in place that capture characteristics of loss events beyond dates and loss amounts. The collection of drivers of operational risk loss events could be insightful if a new industry-wide terminology would be properly defined and drivers would be captured according to standardized driver categories. If such an industry standard for driver categories would be developed in advance of the implementation of the final rule, the collection of drivers could benefit both horizontal analysis by supervisors and analysis by firms in their industry collaborations.

### Disadvantages

As proposed, the term “drivers” is ambiguous as it might appear to be used interchangeably with “causes.” Without a precise definition, the driver information would be exceedingly difficult to collect consistently and would fail to deliver on the advantages noted above. In addition, the proposed requirement has the disadvantage of introducing inconsistent requirements across global jurisdictions.

Care needs to be taken to distinguish between causes of loss events, their impacts, and their drivers. The following might be considered in the discussion of definitions:<sup>2</sup>

- Cause: Gives rise to the risk event. Causes help to categorize the underlying environment that allows a risk event to develop. Causal categories are related to the definition of an operational risk loss event as they are associated with events that result in loss due to inadequate or failed internal processes, people, and systems, or from external events.
- Impact: Categorizes the direct and/or indirect consequences of a risk event for a firm. The outcome of the risk event can be financial/non-financial and direct/indirect, and needs to be measured in a consistent manner. Examples of direct financial impacts include customer compensation, regulatory fines, and legal expenses, while direct non-financial impacts may be regulatory enforcement or reputational damage. Indirect consequences would include opportunity costs related to the loss event.

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<sup>2</sup> This section has leveraged definitions used by the Operational Riskdata Exchange (ORX) in the the 2020 ORX Reference Taxonomy, available at: <https://orx.org/operational-risk-reference-taxonomy>

- Drivers: Factors that directly or indirectly influence the severity of the impact. For example, for a unique event, the operational loss may scale with the number of customers affected, number of transactions, transaction value, or length of time of the event.

Developing an industry-wide terminology based on the above-mentioned considerations requires a meaningful investment of time and resources across regulatory agencies and the banking organizations subject to the requirement to collect driver information. Without this investment, the requirement will not yield the benefit it is intended to provide. It is uncertain whether the envisioned benefits justify the cost. Given that firms already have loss event collection processes in place that capture characteristics of loss events, additional requirements such as the proposed collection of risk drivers should not be implemented.

The level of detailed, descriptive information required in the documentation for an operational risk loss event should scale with the size of the loss amount. The advantages of analyzing larger events in more detail are commensurate with the benefit of related process or control enhancements to mitigate the loss exposure in the future. The thresholds for increased documentation requirements should be set by each institution based on criteria such as loss absorption capacity or other size and scale measures. Unique differences across banking organizations with respect to business mix, complexity, and size necessitate the flexibility for institutions to set appropriate thresholds. This approach would introduce a variety of different thresholds across the industry, which would be appropriate in the context of the institution's risk profile and risk management framework. It is unlikely that most banking organizations would choose to set this threshold at \$20,000, and the final rule should not impose this dollar amount as the threshold for the requirement to document additional descriptive information. As an example, for FR Y-14Q, Schedule E, a detailed description of an operational risk event is only required above a threshold of \$250,000 for gross loss.

Lastly, AORG members do not think that the proposed requirements related to drivers and the level of detail of descriptive information are central to the main objective of the proposed rules, as they are not informing the calculation of operational risk-weighted assets. As such, the proposed requirements are extraneous to the scope of the proposed rule and should be placed elsewhere in the regulatory guidance and requirements.

### **Alternatives**

As mentioned above, suitably flexible thresholds that are appropriate for each firm and operational risk loss type should be incorporated in the final rule, along with clear, actionable definitions.

## **IV. Additional Comments and Requests for Clarification/Revision**

### **A. Timing Losses**

AORG comments with respect to timing losses cover three specific aspects of the proposed rule: Definitions, Thresholds, and Implementation with Retroactive Requirements.

## Definitions

AORG appreciates that the proposed rule provides a definition of timing losses, but we believe additional clarity is required as the current proposal is still not sufficiently clear in certain aspects to distinguish between economic losses and timing losses.

In the NPR's definition of "operational loss," the proposal strikes the word "financial" in "financial loss," presumably to make the point that operational losses include timing losses. However, the proposal then proceeds to introduce some ambiguity with the phrase "including any reduction in previously reported capital levels attributable to restatements or corrections of financial statements." We find the introduction of this phrase confusing, and unnecessary with respect to timing losses. What is the intended connection between "capital levels" and timing losses? If the intent is to refer to timing losses, then there should not be a need to refer to "capital levels." AORG proposes that if the objective is to refer to timing losses, then the statement should read "including timing losses which are already defined to include restatements or corrections of financial statements."

Alternatively, if the objective is to capture reduction in capital, as a broader matter (broader than timing losses), then AORG would suggest that these are not operational losses (not economic and not timing) and we do not support including this type of loss in the definition of operational loss. A reduction in earnings, and ultimately capital, is a typical end result of an operational loss, not the operational loss itself. Including both, is confusing and ambiguous.

Furthermore, AORG believes that the most effective way to define timing losses is to highlight that these losses are restatements or corrections of financial statements that may be resolved with "no money out the door," i.e., do not include an exchange of funds (cash or cash-like instruments) to resolve the matter. When discussing timing losses, the proposal provides examples such as "overbilling." Some AORG members believe that "overbilling" incidents may be considered traditional economic operational losses in cases where the overbilling resulted in the collection of funds which are then disbursed at a later time to resolve the event. In a sense, many typical operational losses are a result of overbilling or overcharging for a period of time, followed by a restitution of these erroneously collected funds. The amount of time elapsed between the collection of the funds, and the restitution (disbursement) is not the only relevant factor. A primary distinction is that, sometimes, the errors are pure accounting matters that can be fully resolved by an accounting journal entry (and not a payment). This accounting entry might lead to a restatement or correction of financial statements, but not to an exchange of funds. This type of error is a timing event, with no full-cycle economic impact, for which a misstatement of prior reporting period is corrected at a later time.

Apart from how they are used, we very strongly favor keeping the definitions of operational loss and timing loss clear, distinct, and separate in the final rule. In addition, clarity of the alignment of the final U.S. definitions of operational loss and timing loss with the BCBS definitions would be helpful, particularly for our banks operating in multiple jurisdictions.

## Thresholds

Timing incidents, as the industry has defined them, are not economic events, full cycle, and should be captured at a much higher threshold which should vary flexibly and appropriately by institution

according to its own definitions of significance in its financial reporting standards versus other traditionally defined operational risk losses.

AORG would like to propose that only timing losses above a certain, significantly higher, threshold be collected as part of the operational loss data. Many timing losses are not economic events, full-cycle. There are countless minor corrections that typically go both ways (favorably/unfavorably) and are not impactful overall. Collecting these would create a significant burden without much benefit.

There are multiple ways to establish a threshold in the context of the rule. AORG suggests that rule-makers refrain from establishing a fixed dollar threshold as financial institutions vary in size and therefore the materiality of the fixed threshold could be significantly different across the community of banks. Rather, AORG suggests that a threshold relative to the size of institutions be considered. Alternatively, the threshold could be based on disclosure requirements for the misstatement.

The proposed rules sweep into one definition incidents that are resolved purely with accounting entries as well as incidents that are resolved with money going “out the door.” If the final rule does sweep these together, then each category should have its own threshold. The pure accounting errors, for which no money flows into/out of the firm initially or upon correction, should have a substantially higher threshold, one that is tied to each firm’s definitions of significance with respect to financial statement details and disclosure. These accounting errors swing in both directions, are often detected by routine controls, and as a result, capture at the level of \$20,000, individually, has no meaningful risk or capital management benefit to support the capture of the data.

### **Implementation with Retroactive Requirements**

Finally, AORG highlights that it is particularly important to our constituents that the requirements for timing losses not be imposed retroactively. These incidents have not been used in AMA data sets, in general, and have been excluded from the FR Y-14Q collection. It would be extremely burdensome for our banks to try to capture this information retroactively and, more importantly, the data captured would not lead to any significant risk management benefits.

### **B. Requests for Clarification/Revision**

The AORG has identified the following areas of the NPR for which further clarification and/or revision is needed in the final rule:

#### **Definition of Operational Loss**

The definition of operational loss is not clear enough. The proposal defines an “operational loss” to include all losses (excluding insurance or tax effects) resulting from an operational risk loss event, including any reduction in previously reported capital levels attributable to restatements or corrections of financial statements. As mentioned above, it is not clear whether this refers to timing events, or is broader, and it is not clear enough whether this refers only to restatements of prior period financials, or to correcting entries that only effect the current period financials, but correct for prior period errors. Restatements of publicly disclosed financial reports are rare, and only occur at very high levels of materiality with thresholds that vary, appropriately, by firm. Clarification of this definition, with

specific examples, is needed, particularly with respect to the references to capital levels and the scope for timing losses.

Under the proposal, a negative financial impact that a banking organization books in its financial statement due to having incorrectly booked a positive financial impact in a previous financial statement would constitute an operational risk loss (these losses are generally known as “timing losses”). Examples of an incorrectly booked positive financial impact would include revenue overstatement, overbilling, accounting errors, and mark-to-market errors. Corrections that would constitute operational risk losses include refunds and restatements that result in a reduction in equity capital. If the initial overstatement and its correction occur in the same financial statement period, there would be no operational risk loss under the proposal. Clarification of the relevant accounting period is requested, e.g., fiscal quarter.

### **Data-related Comments and Requests for Clarification/Revision**

Use of the term “material” for \$20,000 is not in keeping with the use of the same term for public financial reporting. A new term should be used in the final rule, e.g., “recordable,” and significance in the context of the firm (and its own definition of material) should be considered in setting various thresholds, by risk or event category, for recordable items.

We have questions about the following language in the NPR addressing recoveries: “Reductions in the legal reserves associated with an ongoing legal event would be treated as recoveries for the calculation of total net operational losses.” It is not clear to us whether this is intended to include the establishment of and increases in legal reserves for ongoing legal events, i.e., open legal cases.

The following items are among a significant number of areas related to cycle dates, and lags for using required data:

- Treatment (use and reporting) of events with financial impacts crossing the 10-year historical window.
- Which historical loss events should be included in the 10-year lookback period for SMA? If a firm has an event included in a prior period because it pierced the \$20,000 net threshold, and there are recoveries in a subsequent period causing that event’s net loss to fall below \$20,000, does it drop out of the reportable population, or do you continue to report on the event until all impacts roll off?
- Calendar for use of data that is included in the ILM on a quarterly basis. Clarity that internal loss data inclusion would be based on when internal loss event information is captured/enriched in the bank’s risk system, allowing that loss events for a particular quarter-end may be included in the following quarter’s ILM after completion of data enrichment/recording. For example, if a loss event were incurred on June 30, and is recorded and enriched in the internal loss data risk system on July 15, that event would be included in the bank’s ILM for the first instance for the third quarter. This clarification is needed since the BIC financial information would be based on quarter-end.
- Operational loss data lag period for reporting and use of data: AORG requests clarification about when Basel III capital will need to be submitted after a quarter-end (i.e., will the current FFIEC 101 40-day timeline stand, or will firms have more, or less time to submit their Basel III capital results?). If the 40-day timeline is expected to stand, given the processing time loss data validation

and internal capital preparation would take (before a regulatory submission can be made), we request that the final rule allow for a one-quarter (90-day) lag for the loss data set used in the Basel III Loss Component and ILM, and that the requirements for FR Y-14Q be aligned with this. The proposed one-quarter lag will provide needed time to complete the loss data collection process, review loss events and categorize them by the required threshold, investigate unusual events before validation, conduct independent review/challenge, and complete the overall capital production process (including internal review and public disclosure). Anything less than a one-quarter lag increases the risk that the loss data is not fully validated and will place unnecessary strain on firms to complete all internal steps leading up to their regulatory submission.

- ILD dates for SMA: The AORG suggests that the option to use a more conservative approach should be allowed for simplification (for example, aggregating multiple records to a later date would be conservative in this context because it means that data for the total event will be in the rolling ten-year window for a longer time). Accrual for legal fees is one area where this aggregation/simplification is seen as useful.
- Details such as precise dates within quarters (e.g., for elements such as occurrence or discovery) on, e.g., small/old events where such details are not significant for capital calculations and should not be required.
- AORG suggests that for simplicity, the rule might allow for the use of all validated data as of quarter-end. Anything captured in the system as draft and not fully signed-off would not be included in capital production, or FFIEC 101 and FR Y-14Q Schedule E reporting, until the following quarter.

Clarity and/or confirmation and change is requested on the following to ensure alignment of the proposed changes to the FR Y-14Q Schedule E requirements<sup>3</sup> with the proposed Basel III final rule:

- Clarification is requested that, in alignment with the timeframe for the Loss Component's calculation, only the last 10 years of loss history is required in the FR Y-14Q Schedule E.
- Clarification is requested in the instructions that the \$20,000 threshold can be applied retrospectively to historical losses reported in Schedule E.
- The proposed changes to the FR Y-14Q Schedule E requirements state that the \$20,000 data collection threshold be inclusive of non-insurance recoveries. We request clarification of the interpretation of this change based on the following hypothetical situation:
  - A gross loss of \$50,000 occurs and a non-insurance recovery of \$40,000 is received within the same reporting period (calendar quarter), leading to a net loss of \$10,000. Is this operational risk event not to be reported because its net impact is below the \$20,000 threshold?
  - Secondly, if the gross loss occurs in a given reporting period and the recovery is received in a subsequent reporting period, so that the net loss of the operational risk event falls below the \$20,000 threshold in the subsequent reporting period, should the loss event be removed from the FR Y-14Q Schedule E in the subsequent reporting period?
  - Thirdly, if the recovery is an insurance recovery rather than a non-insurance recovery, (regardless of when the insurance recovery is received) does the reporting requirement mean that the gross loss and the recovery amount are to be reported on the FR Y-14Q Schedule E, even if the net loss is below the \$20,000 threshold?
- No changes are proposed for the reporting field "Is Loss Event Included in the Institution's Most Recently Reported Operational Risk Capital Estimate?" The description of this field still

<sup>3</sup> Available at [https://www.federalreserve.gov/reportforms/formsreview/FR\\_Y-14Q\\_Instructions\\_B3.pdf](https://www.federalreserve.gov/reportforms/formsreview/FR_Y-14Q_Instructions_B3.pdf)

references the use of a statistical model to estimate capital. AORG recommends a requirement to report exclusively those operational losses in the FR Y-14Q Schedule E that are also used in the calculation of operational risk-weighted assets.

- For the reporting field “Unit of Measure,” no changes are proposed. The concept of units of measure no longer applies to the standardized capital calculation, so the AORG proposes the removal of this reporting field.
- The modified definition of operational risk loss needs more clarity, specifically relating to "reduction in previously reported capital levels attributable to restatements or corrections". An example would help to understand the intended application.
- Clarify if accrual date is only required for legal settlements or for all losses including settlements, as there is a distinction made in the accounting date definition for legal settlements.
- Clarification is requested in the instructions that source documentation retention to support loss events reported is required to be kept in alignment with bank-defined internal retention periods.
- Given Schedule E reporting would be at the impact level under the proposal (currently at event or impact level), we request confirmation for simplicity in reporting that Schedule E can include negative and positive amounts for an event to align with accounting movements in the general ledger for an event.

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In conclusion, the RMA AORG supports the agencies’ goal of implementing Basel III for Large Banks and believes changes are needed in the final rule to eliminate excess conservatism, to eliminate industry effort on impractical requirements that do not generate a significant benefit in terms of risk management and measurement or balanced capital adequacy, and to afford banking organizations the opportunity to implement the rules with appropriate flexibility to reflect unique differences across our member firms (including with respect to scale, diversity, business mix, complexity, and loss absorption capacity).

Should there be any questions concerning the comments reflected above, kindly contact Edward J. DeMarco, Jr., at [edemarco@rmahq.org](mailto:edemarco@rmahq.org) or 215 446-4052.

Very truly yours,

*Edward J. DeMarco, Jr.*

Edward J. DeMarco, Jr.  
General Counsel

## Exhibit A About The Advanced Operational Risk Group (AORG)

AORG was formed in 2005 as the AMA Group 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.

AORG's mission is to conduct regular practice-sharing exercises among members and pursue an ongoing industry-regulatory dialogue toward the advancement of operational risk management. In fulfilling its mission, AORG sponsors a series of working groups, periodic range-of-practice surveys, and roundtable discussions. AORG consists of operational risk management professionals working at financial service organizations operating in the United States. Institutional membership in the AORG is by arrangement with RMA, and is open to any financial firm regulated in the U.S. that is pursuing advanced operational risk measurement and management practices, and/or is required to conduct CCAR/DFAST exercises. A senior officer responsible for operational risk management serves as the primary representative of each member institution on the AORG.

Since its inception, the Group has supported advanced operational risk management and the fundamental goals of improving operational risk management practice and ensuring capital adequacy. To achieve these goals AORG has promoted the view that regulatory agencies must address two broad themes as they continue to move from policy development to supervisory and examination practice, including: (i) operational risk regulation should remain principles-based vs. prescriptive in nature, and (ii) a proper balance between management and measurement should be maintained.

The institutional members of AORG during the current RMA fiscal year are listed below.

Bank of America	Morgan Stanley
BMO Financial	MUFG Bank
BNP Paribas	Northern Trust
BNY Mellon	PNC Financial
Capital One Bank	Royal Bank of Canada
Citigroup	Santander
Deutsche Bank	Société Générale
Fifth Third Bank	State Street
First Citizens Bank	TD Bank Financial Group
Goldman Sachs	Truist
Huntington	UBS
HSBC North America	U.S. Bank
JPMorgan Chase & Co.	Wells Fargo
Keycorp	Zions Bank
M&T Bank	

Support for AORG is provided by RMA and Greenwich Risk Management Consulting LLC.