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

May 29, 2001

RE: Comments on the Consultative Package of The New Basel Capital Accord

Dear Sir or Madam:

The second consultative package of "The New Basel Capital Accord" ("the Accord"), released by the Basel Committee on Banking Supervision on January 16, focuses on improvements in the measurements of risk and impact on capital requirements. The Committee has requested commentary on various aspects of the Accord and associated consultative documents. In their "Summary of the Basel Committee's 'The New Basel Capital Accord'" the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency highlighted a number of specific issues of particular significance for the US banking system and indicated that comments on these issues would be particularly welcome.

Mellon Financial Corporation, the parent of Mellon Bank, N.A., Pittsburgh, Pennsylvania, has reviewed the Accord as issued by the Basel Committee on Banking Supervision. We strongly object to adoption of the Accord as contemplated in its current form. The 500 plus pages of the Accord contain innumerable sections, paragraphs and calculations which are dependent upon either further study, or later definition of terms and variables.

- Adoption of the Accord without opportunity for further comment on the definition of these "to be determined" elements is imprudent from a regulatory perspective and unfair to regulated institutions.
- New rules regarding minimum capital should not be established until such time as they are fully defined, providing all parties a meaningful opportunity to consider their impact and comment in a meaningful fashion.
- Further study is needed in order to assess the extent to which the proposed accord is capital neutral, as intended, and to provide opportunity for industry comment on additional changes to the accord to address the above concerns.
- Further study by all parties is also warranted in order to identify and consider the unanticipated consequences of the adoption of the Accord.

General Comments

- It is apparent that certain provisions of the Accord were drafted to accommodate the financial, legal and social realities of various countries. For example, the collateral categories discussed under Credit Risk do not encompass typical collateral taken in the U.S. in commercial lending, such as receivables, inventory, etc. (In this instance we understand that in certain jurisdictions, enforcement of a non-possessory security interest is uncertain or impossible.) To the extent that such factors influence the drafting of the Accord, U.S. institutions are put at a significant disadvantage.

- If implemented, the proposal will provide powerful incentives for institutions engaging in certain activities to abandon their banking charters and select a less regulated organizational form in which to conduct the same activities. This will increase systemic risk by causing the migration of assets and activities outside the banking system.

- The inclusion of a capital charge for Operational Risk under Pillar I is inappropriate. Operational Risk is much better addressed under Pillar II, Supervisory Review. The basis for the charge for Operational Risk set forth in the Accord is extremely arbitrary, and fails to take into consideration many of the complexities and existing control mechanisms which differentiate financial institutions with significant operating businesses.

- Moreover, while operational risk may affect gains or losses in an institution's operating income, only in truly extraordinary cases do charges to capital result from operational risks; this fact underscores the inappropriateness of treating operational risk through a capital approach.

- In considering Operational Risk, the emphasis of the Accord appears to be focused on Pillar I and Pillar III issues. The importance of Pillar II, Supervisory Review, cannot be overstated. An important component of effective review is the relative strength of an institution's risk management and risk control programs. U.S. regulators have made significant strides in moving to supervision by risk methodologies. As part of this review methodology, regulators consider both the nature of the risks faced by an institution as well as the strength of its risk culture and risk management programs. Only an approach such as those contemplated under Pillar II provide the appropriate vehicle for regulators to consider these elements. Such an approach is superior to arbitrary formulas for determining the appropriate level of regulatory capital.

- The threat posed by the Accord to the ability of banks to compete in the global marketplace is extreme. As banks have moved beyond their traditional roles to enter new businesses and seek new markets, they compete with many companies not subject to the same or any regulation. Promoting mandatory capital charges as

considered for Operational Risk places these companies at a competitive disadvantage and as a result, actually increases the degree of business risk they face.

- Our response to the provisions of the Accord are based upon the recognition that certain risks are best dealt with using objective standards and tools, while others lend themselves to a more subjective or tailored approach.

  - It is clear that both credit risk and operational risk are important issues facing financial institutions. However, the nature of these two risks is quite different. Broad comparability exists from bank to bank in assessing credit risk. For example, $100MM in exposure to a "AA" rated borrower carries a very similar risk profile from bank to bank.

  - The same cannot be said of the risk profiles of two different banks providing cash management, securities custody or asset management services. The risk to each institution is very dependent upon the strength of its control systems, the size and complexity of its operations, and the risk culture of the institution itself.

  - Each of these distinct products (cash management, securities custody and asset management) carry different types of risks, are subject to very different types of controls, and the marketplace factors the degree of risk posed by each into the pricing of each product.

  - In dealing with credit risk, the comparability of risk from institution to institution lends itself well to a capital allocation system that is based upon objective standards; i.e., an approach such as the Standardized Approach under the Accord.

  - In contrast, operational risk that is subject to a very large number of forces and variables does not fit well into an objective approach; one size will not fit all.

Pillar I – Minimum Capital Requirements

As a backdrop, in considering which capital rules should be imposed upon banking institutions, regulators and banks should recognize that a significant constraint upon capital maintained by any banking institution is the public market for that institution's securities. Investors and rating agencies bring great power to bear upon the consideration of what constitutes appropriate capitalization. Any regulatory standard that reduces bank capital will not necessarily lower capital holdings, as investors and the public market will continue to enforce the market's sense of appropriate capitalization.

Credit Risk – The Standardized Approach

- Revision of existing capital standards as related to credit exposure is appropriate insofar as the existing standards do not adequately consider the underlying risk profile of an institution's loan portfolio. The assessment of capital based upon assigned risk weights associated with the ratings of external credit assessment institutions would be a major advancement. Such a mechanism provides institutions an incentive to consider higher rated (lower risk) loans even given a lower yield.

- Use of the Standardized Approach as described provides an objective standard to the allocation of capital to credit risk across numerous institutions. There is no factor of human judgment/prediction, and "gaming the system" is not likely.

- Reducing capital requirements for credit accommodations backed by collateral or guarantees as noted is also appropriate. Nonetheless, many institutions hold non-financial collateral which in many instances carries significant value, and substantially reduces overall credit risk. Provision should be made for such non-financial collateral where appropriate advance rates are in place.

- The introduction of a credit conversion factor (20%) to commitments with an original maturity of up to one year will alter the cost structure of the existing market for "364 day commitments". Initially at a higher cost, banks will be less willing to extend these facilities. Further, inclusion of this charge renders any of the methods for capital calculation related to Credit Risk beyond the Committee's goal of remaining capital neutral. There is no way to include this charge and claim a goal of capital neutrality at the same time.

- The use of the "w" factor in assigning value to collateral is problematic. A factor in calculations which further haircuts collateral valuations based upon uncertain events is punitive in nature, and there does not appear to be a good reason to include such a factor. To the extent that institutions set aside capital against operational risk, such a factor at a minimum results in a double counting of such risk.

- We find the use of the "w" factor, and the overall concept of collateral haircuts to be problematic when applied to a securities lending business. In this case, no consideration is given to the fact that the collateral and the securities lent may very well experience similar impacts on market value. (That is to say, that when market forces drive the value of collateral investments down, they likely drive the value of the security lent down as well.) In such circumstances the application of a collateral haircut is inappropriate. Securities Lending firms are then further punished by application of the "w" factor.

Credit Risk – The Internal Ratings Based (IRB) Approach

- Both IRB approaches suffer from two deficiencies

    1. Potential of Unequal Treatment. The potential for a lack of comparability exists insofar as institutions are allowed to adopt a capital allocation mechanism dependent in part upon their own data. As regulators approving such mechanisms will vary widely in their capabilities and biases, unfairness is likely to result. The motivation for some institutions to "game the system" will be high.

    2. Lack of appropriate definition. As currently drafted, sufficient information does not exist to accurately proforma capital charges under the IRB approaches. Although many institutions maintain data on *probability of default* (associated with credit migration studies, etc.) appropriate current data on *loss given default* is very difficult to obtain. One of the reasons for this is a lack of a large enough population in any institution's database. As a result, public debt data may need to be substituted. Further, the likelihood of any institution – or regulatory body for that matter – possessing current and accurate data on the *outstanding amount at the time of default and remaining maturity at the time of default*, is highly unlikely.The accuracy of any calculation derived from sources such as these would be weak at best.

- Model based approaches, no matter how artfully designed, may not lead to prudent results from a risk management perspective. This is one of the important lessons of Long Term Capital Management. Encouraging institutions to adopt such approaches, in lieu of the objective standards of the Standardized Approach, may well lead to undercapitalized institutions and a false sense of safety.

Asset Securitization

- We agree that securitized assets should only be removed from a balance sheet for purposes of calculating capital if those assets are transferred legally via true sale. This is the "clean break" concept laid out in the Accord.

Operational Risk – Summary Observations

- We agree that economic capital should be allocated to cover operating risk. We currently allocate capital to each of our lines of business to assess operating performance and as a matter of sound business practices. However, the assignment of regulatory capital by formula across a wide range of institutions with varying business profiles is inappropriate; operational risk is better the province of Pillar II – Supervisory Review Process. There, each board and senior management is responsible for assessing the risks faced by the institution and appropriately assessing capital. In addition, provision is made for internal and supervisory reviews. If an imprudent risk profile is noted, or if capital is inadequate to address a risk profile, supervisors may call on the institution to bolster its capital. Minimum capital derived by formula is not an appropriate response to the complexity of this problem.

- In considering the degree of risk operational losses pose to banks, it needs to be recognized that certain of the "losses" absorbed by a bank come about not because the bank is at fault, but rather due to the relationship with a client. A hard-nosed business judgment to settle matters by the bank absorbing a loss in order to preserve the business relationship with the client for the future is a business expense, not the equivalent of an operational loss.

- Should the Committee determine that Pillar I capital treatment is appropriate in lieu of Pillar II Supervisory Review, the Basel rules should encourage effective risk management in the context of existing systems in each regulated institution. A series of capital allocation approaches should be offered, allowing institutions with sophisticated risk management systems to calculate required capital based on a variety of factors, including the institution’s loss experience.

- The target level of 20% of an institution’s economic capital leads to a gross simplification of the risks faced by a particular institution. Only detailed internal and supervisory analysis can lead to a determination of what level of capital is appropriate.

- The Committee should consider the competitive environment faced by banking institutions. Care must be taken to maintain or enhance a level playing field where non-bank competitors are not inadvertently advantaged via bank capital mandates.

Operational Risk – The Basic Indicator Approach

- The *Basic Indicator Approach* allocates capital as a fixed percentage of gross income. This approach is inadequate because the level of gross income bears very little relation to the level of risk inherent in an institution’s operations. Although regulators may have a preconceived notion of the percentage level of capital that should be assigned to an institution, such an approach ignores the underlying risks and control systems in place in each regulated institution.

Operational Risk – The Standardized Approach

- The *Standardized Approach* allocates capital based upon to be determined beta (β) factors to be established for each of seven business lines associated with three business units. This mechanism is inappropriate for the following reasons;

  1. The Committee itself notes that further assessment, wider testing and verification of the suggested approach is needed. Thus imposing such standards on the banking industry without opportunity for meaningful review and comment is not fair to the banking community and will not lead to a complete vetting of the issues. Adoption of such a standard on a global basis in light of these deficiencies is premature. Meaningful study is impossible without definition of the beta factors.

  2. Targeting Operational Risk regulatory capital at the "assumed industry average" of 20% of economic capital" is extremely arbitrary. Such a target fails to take into consideration the varied business approaches of banking institutions, as well as failing to reward banks with good risk management approaches for such practices.

  3. As with the Basic Indicator Approach, it is assumed that volume of activity is an acceptable indicator of the level of risk inherent in the business activity. This is not the case. If a cash management business processes $100MM of throughput each day, its risk is not doubled if it processes $200MM of business.

  4. The approach bears no relation to an institution's actual loss experience.

  5. The Standardized Approach, requiring a bank's activities to be broken up into business lines is overly simplistic and ignores the wide variety of products offered by the banks. Defining the business lines will be different for each Bank depending on how the bank is organized and managed. (The selection of business lines in this approach overlooks the operational realities faced by many organizations. For instance Custody, FX and Securities Lending activities are not necessarily easily separated, and may all be undertaken for a client in relation to one or a number of transactions. Identifying the appropriate activity and level of risk is very difficult. As drafted, this approach would likely lead to an over-counting of activity across a broad number of business functions.)

  6. In addition to not considering the operational realities of individual organizations, the approach fails to consider the realities of individual contracts entered into by these institutions with their customers. These underlying agreements are highly customized, and render a one size fits all approach of assigning capital by assumed business practice meaningless. Establishing target capital factors for business activities which are not homogeneous in nature does little to address or mitigate the underlying risks faced by banking institutions.

7. The Standardized Approach fails to reward effective risk management. By relying on the statistical analysis of industry databases invalid conclusions may result given the lack of data and the lack of comparability among the institutions. A bank with poor controls would have a high loss experience and would bias the allocation upward. This is unfair to a bank with better controls and low loss experience. Conversely, the bank with poor controls would be allocated inadequate capital based on a common factor. Applying a straight-line approach for all banks based on size and or revenue while not recognizing their individual differences would result in inequitable capital charges. These concerns would also apply to the Internal Measurement Approach.

Operational Risk –The Internal Measurement Approach

- This approach is the most interesting of the three operational risk approaches, providing discretion to individual banks on the use of internal loss data, while the method to calculate capital is set by the supervisors. However, " Currently, there is not sufficient data at the industry level or in a sufficient range of individual institutions to calibrate the capital charge under this approach." (Page 8, Consultative Document Operational Risk.) In this light it appears that neither the Committee nor its constituent regulators would allow an institution to adopt such an approach.

- The Internal Measurement Approach is the most attractive, insofar as capital is allocated based upon true loss potential, rather than an arbitrary 20% of economic capital. We agree that there is limited data regarding catastrophic and ordinary loss in the processing businesses. We contend that the allocation of capital absent such data is inappropriate and arbitrary. As a result, Operational Risk should remain the province of Pillar II – Supervisory Review Process.

- The Internal Measurement Approach will use standard business line definitions, exposure indicators, probability of events, loss given events, and gamma factors for all institutions, ignoring the huge differences between banks noted regarding the Standardized Approach.

    - The definition of operating risk includes indirect loss, including opportunity loss and charges accepted for "relationship" reasons unrelated to liability or operational fault.

    - In addition to the database comments above, the potential expense of complex system requirements and the competitive reluctance due to undefined guidelines would add to the concerns.

Pillar II – Supervisory Review Process

- We agree with this approach to risk management where supervisors are expected to evaluate how well banks are assessing their capital needs relative to their risks and to intervene, where appropriate. As stated, this interaction fosters an active dialogue between banks and supervisors such that when deficiencies are identified, prompt and decisive action can be taken to reduce risk or restore capital.

- The four key principles of supervisory review should take precedence over the formula based attempts at capital allocation in Pillar I. Those Principles provide:

  Principle 1: Banks should have a process for assessing their overall capital adequacy in relation to their risk profile and a strategy for maintaining their capital levels.

  Principle 2: Supervisors should review and evaluate banks' internal capital adequacy assessments and strategies, as well as their ability to monitor and ensure their compliance with regulatory capital ratios. Supervisors should take appropriate supervisory action if they are not satisfied with the results of this process.

  Principle 3: Supervisors should expect banks to operate above the minimum regulatory capital ratios and should have the ability to require banks to hold capital in excess of the minimum.

  Principle 4: Supervisors should seek to intervene at an early stage to prevent capital from falling below the minimum levels required to support the risk characteristics of a particular bank and should require rapid remedial action if capital is not maintained or restored.

Pillar III – Market Discipline

- Although we feel it is appropriate to openly share risk information with our regulatory agencies, and have and will continue to do so, the requirement for mandatory disclosure of detailed risk capital elements is not appropriate.

  - Although providing this information might foster a greater level of transparency, it is questionable how individuals and other entities would comprehend or use that information. Banking institutions in the United States already provide substantial disclosures of financial information, and it is our perception that additional mandatory disclosure is not warranted.
  - Wide scale disclosure as contemplated will lead to confusion among users of that information. Although banks would disclose their loan portfolio composition in gross terms, the underlying portfolios themselves may be radically different – especially in the higher risk and unrated categories.
  - This problem is further compounded by the high likelihood of an uneven playing field for many banks. Non-bank competitors, not subject to this level of disclosure may well be advantaged in public opinion. At a minimum, their cost structure for reporting compliance would be significantly less.

- Public access to risk/loss information can have a number of negative consequences, including inappropriate use of the information for competitive purposes and used against banks by class action lawyers. Raw data can be subject to misinterpretation. Some losses, which may have reasonable explanations or which resulted from problems that have been remedied, might require the organization to defend its data in numerous forums, including responding to RFPs and financial analysts. Such open dialogues might jeopardize confidence in the banking system in general, if not in specific institutions, by artificially heightening concern and focusing the debate on matters that might otherwise not be of concern to experienced regulators. Also, disclosure of such information might provide a roadmap for litigators, particularly the class action bar, thus exposing the banking industry to unwarranted litigation with its attendant expense and reputation risks. This information would establish a floor for negotiations and always result in increased cost for the bank.

- Each nation's securities regulation authorities play a central role in addressing disclosure requirements. Their role is as primary regulator in this field, and as such, they make the determination of what constitutes adequate disclosure. Acknowledgement of this role by both banks and the Committee is important in respecting regulatory jurisdiction and avoiding inconsistent regulatory requirements from bodies possessing differing authority.

- In principle, some portion of Pillar III appears acceptable and in keeping with current securities regulation, accounting principles and/or business practice. However, other elements of Pillar III which include mandatory detailed disclosure of Credit Risk, Market Risk, Operational Risk and Interest Rate Risk – including detailed disclosures

of calculations, formulas, and risk variables are not appropriate for wholesale public dissemination. Further, these seem beyond the bounds of banking regulators. Mandatory disclosures such as these set forth in the Accord should be eliminated.

Conclusion:

We appreciate the opportunity to review the Accord and recognize that significant work has gone into its creation. Nonetheless, adoption of the Accord without further study and significant revision, coupled with the opportunity for further comment, is inappropriate. In summary, we are very concerned with:

- The wide range of undefined or to be determined elements in the Accord;
- The impact of the Accord versus its stated goal of maintaining capital neutrality;
- The very real threat to businesses regulated under the Accord in terms of their ability to compete against firms not regulated under the Accord;
- The inclusion of a formula charge for Operational Risk under Pillar I;
- The failure to consider the value of other forms of collateral for commercial credit facilities;
- The use of the "w" factor in establishing collateral values; and,
- The breadth of the market disclosure rules considered under Pillar III and the negative consequences which would accrue to institutions meeting this standard

We thank you for the opportunity to comment on "The New Basel Capital Accord" and associated consultative documents. If you should have any questions about our comments or would like to discuss them further, please call Michael Bleier, General Counsel, at 412-234-1537.

Sincerely,

Steven G. Elliott
Senior Vice Chairman and
Chief Financial Officer
Mellon Financial Corporation

CC: Office of the Comptroller of the Currency
Federal Reserve Board
Federal Deposit Insurance Corporation