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

Directorate General (Internal Market and Financial Services)
European Commission
Av. de Cortenberg, 107
B 1049
Bruxelles

Dear Sirs

Response to the Basel Committee on Banking Supervision and the European Commission on Proposals for the New Capital Accord

Merrill Lynch & Co., Inc. ('Merrill Lynch' or 'we')[1] very much welcomes this opportunity to respond to the Basel Committee on Banking Supervision ('the Basel Committee') on its proposals set out in the New Basel Capital Accord ('the New Accord') published on 16 January 2001, and to the European Commission on its proposals set out in the Commission Services' Second Consultative Document on the Review of Regulatory Capital for Credit Institutions and Investment Firms ('CAD3') published on 5 February 2001.

The original Accord has been in existence since 1988. Given the development of the financial markets since that date, we agree with the Basel Committee's view that a substantial revision to the original Accord is now overdue. Merrill Lynch therefore welcomes the New Accord, in particular the proposals' focus on risk sensitivity. We also appreciate the openness and consultative tone of the New Accord, and trust that this approach will continue.

Although we welcome the New Accord, we have some comments set out below. These comments fall into three categories:

1. matters on which clarification is sought;
2. matters of potential adverse market impact; and
3. suggested revisions to the proposals.

These comments are summarised in the Executive Summary and expanded upon in section 2 "Particular issues". Although we document herein our main concerns, we have fully participated in, and accordingly generally endorse the responses of trade associations of which we are a member. These are the London Investment Banking Association ('LIBA'), the British Bankers Association ('BBA'), the International Swaps and Derivatives Association (ISDA), the Institute of International Finance ('IIF') and the Bond Markets Association ('TBMA').

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[1] *This response represents the view of Merrill Lynch & Co., Inc., the parent of the Merrill Lynch group, and sets out the views of the group as a whole. Merrill Lynch is one of the world's leading financial management and advisory companies with offices in 44 countries and total client assets of about $1.6 trillion. As an investment bank, it is the top global underwriter and market maker of debt and equity securities and a leading strategic advisor to corporations, governments, institutions and individuals worldwide. Through Merrill Lynch Investment Managers, the company is one of the world's largest managers of financial assets. For more information on Merrill Lynch, please visit www.ml.com.*

In our response to the first consultative paper we argued that flexibility was a paramount issue if the proposals were to be applied to a diverse audience. Flexibility is vital to ensure that:

- firms are able to chose which of several capital approaches are appropriate;
- firms can continue to innovate their risk management practice without being forced into a 'one size fits all' approach; and
- the proposals are and remain appropriate to all firms as the industry develops.

We are pleased that the Basel Committee has endorsed the first of these objectives. The second objective may be hindered by the New Accord being too prescriptive, with the potential result that innovation could be stifled. The last objective remains a significant concern especially within the EU where the application to investment firms as well as banks will require particular care. Thus, whilst we appreciate that the 2004 deadline is well established, we believe that there are elements of the proposals such as the Trading Book issues which could be placed on a slower track without materially affecting the success of the New Accord.

We hope that you consider our comments helpful. We are very happy to clarify and discuss any matters in this response. Please feel free to call or e-mail David Murphy (+44-20-7867-4229 or david_vj_murphy@ml.com), Steve Teather (+44-20-7867-4848 or steve_teather@ml.com) or Dominic Carone (+1-201-671-0130 or dominic_carone@ml.com).

Yours sincerely,

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Finance Director	**Treasurer**
Merrill Lynch & Co., Inc.	**Merrill Lynch & Co., Inc.**

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1 Executive summary

We set out below a bullet-point summary of the significant issues as we view them. We believe that these matters are echoed by the wider industry. Most points are referenced to section 2 "Particular issues" where a fuller explanation of the issue will be found.

1.1 Matters on which clarification is sought

- It is not clear if the credit risk and credit risk mitigation proposals for the Banking Book carry-across to the Trading Book (see section 2.2.2 "Credit risk proposals in the Trading Book", section 2.4.1 "Credit derivatives and guarantees" and section 2.4.7 "Stock lending and repos"). We would appreciate clarity on this issue.

- The Credit Risk Mitigation ('CRM') proposals do not specify the risk the *w* factor is meant to address, although it appears from subsequent discussions that the concern is to address "documentation risk", "legal risk" or other "residual" risks (see section 2.4.1 "Credit derivatives and guarantees"). A more precise definition of *w*'s purpose would be welcome.

- We would also welcome a detailed description of the Basel Committee's concerns and of the precise nature of the risks the operational risk charge is intended to cover (see section 2.3.1 "Definitional issues" and section 2.3.2 "Additional detail needed").

- We are concerned that different weightings are to be applied under the Standardised Approach to equally rated corporates, banks and sovereigns. External ratings imply the same expected loss irrespective of the type of entity, so we would welcome clarification of why these differences exist. By the same token, we are concerned that there is a separate scale of weightings for securitised assets. Given the key role of ratings in the New Accord, we suggest that all obligations of a given rating should be treated equally.

1.2 Matters of potential adverse market impact

- There has been some suggestion that the current Banking Book treatment of repos and stock lending be carried across to the Trading Book. This could be damaging to markets that are the key sources of short-term liquidity for many institutions (see section 2.2 "Impact on investment firms" and section 2.4.7 "Stock lending and repos").

- The proposals for *w* may reduce the liquidity of the credit derivatives market, discourage prudent hedging of credit risk, and increase the cost of risk mitigation (see section 2.4.1 "Credit derivatives and guarantees").

- We also have a wider concern, namely that the proposals have given insufficient consideration to the impact on the Trading Book in general and hence firms with large Trading Books in particular (see section 2.2 "Impact on investment firms"). These organisations will, we believe, be disproportionately affected by the operational risk charge and may not significantly benefit from the credit risk proposals. In our opinion, if left unchanged, the Accord could have a detrimental impact on markets and on investment firms. In certain cases these impacts may be so serious as to call into question the viability and/or geographic location of these organisations. This is particularly so if the Basel Committee, despite its commitment not to make significant changes to the Trading Book, were to apply the CRM proposals outside the Banking Book. We therefore urge the Basel Committee and the European Commission not to make substantial changes to the Trading Book regime.

1.3 Suggested revisions

- In order to emphasise its importance, we reiterate our concern that any application of the CRM proposals to the Trading Book will increase systemic risk. The European Union's current Trading Book regime is working well so, whilst welcoming further study on this important topic, we recommend that the Basel Committee adopt the EU regime as a temporary measure until a new Trading Book regime is developed. The new regime will have to be carefully researched for the reasons alluded to above, and should incorporate a thoroughgoing revision of the rules relating to specific risk. We would be happy to participate in this effort. We note the suggestions put forward by BBA/LIBA and ISDA in this respect. We regard these suggestions as a sound basis for the review of the Trading Book regime.

- Given that many areas in the proposals remain incomplete, it is important that the Basel Committee consults the industry again on the significant areas of change, especially operational risk, the treatment of securitisations, and revisions to the disclosure regime (see section 2.1.2 "The need for further consultation").

- We do not believe that *w* is a proportionate response to the risk associated with credit risk mitigation (see section 2.4.1 "Credit derivatives and guarantees"). As noted in section 1.2 "Matters of potential adverse market impact", we believe that *w* may have a detrimental effect that far outweighs the benefit that the supervisors perceive it delivers. The implementation of *w* is also inconsistent in that bank guarantees and credit derivatives are viewed differently.

- We are also disappointed to see that the operational risk proposals are a core requirement of the Pillar 1 proposals, and not a component of Pillar 2 as we argued in our response to the first consultation paper. We believe that the imposition of capital charges is not an appropriate response to these risks. Robust controls and procedures are the most effective means of mitigating operational risk, and so lend themselves to supervisory monitoring under a Pillar 2 approach. The Pillar 1 proposals, moreover, are disproportionately penal. If supervisors do wish to impose a Pillar 1 charge despite the strength of the arguments for Pillar 2, we believe that five changes would substantially improve the proposals. These are: (1) the charge should be calculated using a sub-linear function; (2) a revised calibration should be developed which fully reflects the operational risks of investment firms as well as banks; (3) flexibility must be available to allow the implementation of the Loss Distribution Approach; (4) the charge must reflect the quality of a firm's control environment as well as its size; and (5) routes must be available to allow new exposure indicators to be available for capital purposes once they have been developed and validated. See section 2.3 "Operational risk". A phased in approach to operational risk may be warranted.

- We believe that transparency will be enhanced if supervisors were to disclose high-level details of their supervisory approach. For example the distribution of firms having capital charges above the minimum could be disclosed (i.e. the percentage of firms with capital requirements between 8% and 9%, 9% and 10% etc.). This would act in the same way as the disciplines of Pillar 3, and in our view would be a strong incentive to ensure level playing fields (see section 3.4 "Supervisor transparency").

- The Pillar 3 proposals will be onerous to prepare and inconsistent with accounting standards. Arguably, they are inappropriately targeted and may lead to the publication of proprietary information without significantly enhancing market discipline. In this context we suggest that financial statements are not the right vehicle for the publication of Pillar 3 disclosures, especially at the legal entity level. We propose a different approach that has the benefit of avoiding obfuscation of financial statements, whilst allowing analysts and credit rating agencies to review appropriate information (see sections 2.5.5 "Means of disclosure" and 2.5.6 "Legal entity disclosure").

- The International Accounting Standards Board ('IASB') would seem the appropriate body to produce accounting disclosures, and we would welcome enhanced co-operation between the Basel Committee and them (see section 2.5.7 "Accounting Standards").

- We do not believe that investor protection will be improved by adopting consolidated supervision for mono-line subgroups such as asset managers if the subgroup is already appropriately supervised on a stand-alone basis (see section 2.6 "Consolidated supervision").

1.4 Conclusion

If Merrill Lynch had large amounts of Banking Book risk compared to its Trading Book risk, we would find it easier to support the proposals as a package. Whilst we recognise that the proposals were developed for internationally active banks, they will be applied to a much wider body of financial organisations, especially in Europe, so it is not surprising that there are areas of significant concern where the wider group of firms differ from Basel banks.

The proposals for operational risk and credit risk mitigation as currently drafted may have a significant adverse impact on firms, markets and customers. We believe that further work needs to be done on these areas in relation to all affected firms, and we are happy to contribute to these efforts. Aside from these areas, we also believe that the disclosure and consolidation requirements are onerous and unnecessarily wide ranging; the same supervisory objective could be achieved within a narrower and more effective approach.

We strongly believe that the net effect of the proposals will be to provide significant competitive advantages to internationally active banks with large loan books and competitive disadvantages to investment firms, especially in Europe. We fear that this will be at the expense of European customers and European investment firms. We do not believe that this is either the Basel Committee's or the European Commission's intention.

2 Particular Issues

2.1 Completeness of proposals

Both the New Accord and CAD3 are incomplete. The main areas of imprecision from our perspective concern the treatment of operational risk and of asset securitisation. We are concerned that these complex areas may not be subject to further consultation. Given that the New Accord must stand the test of time, and that the proposals in both of these areas could have a considerable impact, it is important that detailed proposals in these areas are made available for discussion before the full Accord is finalised.

2.1.1 The difficulty of assessing impact

When trying to assess the New Accord, it is natural to start by determining their quantitative impact, both on our own balance sheet and on the market place in general. However, the state of completeness of the proposals does not allow us to do this with any degree of certainty. In particular we note the following areas that are substantially incomplete:

- operational risk generally (and in particular the beta and gamma factors);
- the handling of synthetic securitisations;
- the treatment of credit risk mitigation instruments in the Trading Book; and
- more broadly, the application of proposals to the Trading Book and investment firms in particular.

The first area is discussed in more detail in section 2.3 “Operational risk”, and the Trading Book uncertainty is elaborated in section 2.2 “Impact on investment firms”. The proposed treatment of synthetic securitisation is of particular interest to Merrill Lynch due to the potentially negative impact on this progressive market. The proposals for credit risk mitigation instruments such as credit derivatives are only relevant in the context of a simple "originate a loan, buy protection" Banking Book scenario. They do not address the more usual Trading Book situations of credit derivatives hedged with other credit derivatives, basket credit default structures, or the whole issue of portfolios of credit derivatives on the same obligator, and could therefore be inappropriate if read across to the Trading Book.

2.1.2 The need for further consultation

We appreciate that most of the areas mentioned are still under discussion and policy is still under development. Given the importance and the likely impact of the proposals, both on individual firms and the wider financial industry, we consider it important that the Basel Committee and the European Commission undertake additional consultation; indeed we believe that the process of consultation should continue even after the Accord is adopted so that the risk elements may be modernised as appropriate. Whole areas of financial markets are affected, so it would be inappropriate and perhaps damaging not to seek informed comment. We understand there are timetable constraints, but believe these to be of secondary importance given the scope of the proposed changes. We do not champion re-consultation of the whole package, but focused “mini” consultations on those areas that are either incomplete or subject to significant change.

2.2 Impact on investment firms[2]

Many commentators have concentrated on the impact of the credit risk and credit risk mitigation proposals in the Banking Book. However, it is not clear if these proposals carry-across to the Trading Book. The existence of collateral haircuts (including the *w* factor), the loss of the 50% risk-weighting cap on OTC derivatives and the application of the CRM proposals to the treatment of repos and similar would produce a significant increase in charges.

2.2.1 Significant adverse impact on the system

Our analysis shows the impact of the CAD3 proposals will very considerably increase capital requirements for investment firms. The increase comes from a number of sources: the lack of a significant benefit from the credit risk

[2] Firms with predominant trading books, herein, for ease of reference, are referred to as ‘investment firms’. This will include, but not exclusively, EU investment firms.

changes, compounded by the operational risk charges and the potential carry-across of the credit risk mitigation proposals. Thus, although the proposals for commercial banks may be broadly neutral, for the vast majority of firms with significant trading business they will result in large increases in capital. This is particularly problematic as we believe the largest proportional increases will be in smaller firms such as mono-line asset managers or corporate finance boutiques that have hitherto not been seen as primary sources of systemic risk. The effects on European competitiveness, the extra costs for consumers of financial services in Europe, and hence the impact on successful European firms will be profound.

2.2.2 Credit risk proposals in the Trading Book

The issues are of particular relevance to investment firms, but are also important for banks with large Trading Books:

- The removal of the 50% ceiling on OTC derivatives will increase capital requirements. Industry's experience of OTC counterparties is that defaults are rare, and OTC exposures tend to recover more than their seniority in the ranking of creditors would indicate. Indeed, for one of our significant entities which has been facing clients on significant numbers of OTC derivatives for ten years, there is a record of minimal losses from default despite a substantial credit exposure. This, combined with the professional nature of the market, suggests that the original 50% cap was reasonable and we support its retention.

- Both the New Accord and CAD3 are rather opaque on whether the credit risk proposals (including credit risk mitigation) carry across to counterparty (Trading Book) risk. We have noted comments by some supervisory bodies that there is a general presumption of carry across. On the other hand both Basel and EU consultative documents suggest that there will be no substantive change to the Trading Book regime. Despite the carve-out of certain government bond repo transactions, we believe the imposition of the CRM proposals on the Trading Book would constitute a significant change. We therefore find the presumption problematic. First, the assumption that counterparty risk is inherently the same as credit risk is open to debate, not least because the effective maturity of the exposure in a derivatives transaction is shorter than the contractual maturity because of the effect of early termination and restructurings. Secondly, and more seriously, all the debate and analysis of the proposals has been focused on the Banking Book.

The only explicit changes to the Trading Book regime in the New Accord are those proposed for the treatment of specific risk under the standardised methodology and for the abolition of the 50% ceiling on OTC counterparty risk weightings. Although we do not agree with either proposal, we acknowledge the Basel Committee's consideration of them and welcome the opportunity to comment. We would have welcomed a wider review of the Trading Book regime, an important area, but this opportunity was not taken in this round of consultation. We therefore request that the matter be addressed as a separate exercise in the near future, including in particular consideration of the specific risk regime in the light of modern CRM techniques.

The problem we foresee if the review is not done is that in the absence of specific guidance from the Basel Committee, the European Commission may adopt Banking Book treatments and apply them unchanged to the Trading Book without consideration of the two environments' distinct characteristics. The two environments are very different, however, and inappropriate treatments could be enacted if the differences are overlooked.

We acknowledge that certain aspects of the Trading Book regime need to be amended; in particular, we support ISDA's proposed revision of the add-ons used to calculate the potential future credit exposures of OTC derivatives.

We support the LIBA/BBA and ISDA suggestions for the Trading Book treatment of stock lending and repo transactions. These suggestions are by no means complete, which is a function of the uncertainty of the intentions of the supervisors and the importance of getting it right – there simply has not been enough time to fully establish and evaluate alternative proposals. Therefore, we would seek to improve it as part of the wide-ranging review of the Trading Book regime. Section 2.4.7 "Stock lending and repos" provides further discussion of the impact of the proposals on stock lending and repo transactions.

2.3 Operational risk

The Basel Committee's focus on this important risk class is welcome. Merrill Lynch understands the need to address operational risk, but we do not believe that the current proposals are optimal in a number of areas and would suggest that the final solution needs to be highly flexible to accommodate the expected advances in practice.

We note the Basel Committee's acknowledgement that the 1988 Accord delivered an overall cushion of capital for both measured risks (credit risk and market risk) and other unmeasured risks and that this cushion is likely to be depleted by the revised methods of calculating credit risk in the New Accord. What may not have appreciated, however, is that investment firms will benefit far less, if at all, from the new credit risk charges.

From an intellectual standpoint we are concerned that the proposed charge appears to have been designed more to limit the savings in capital available to banks under the New Accord than to address quantifiable risks. Moreover, from a practical standpoint, we are concerned that the charges under both the Basic Indicator Approach and the Standardised Approach (insofar as these can be determined) dwarf the economic risk.

We believe that a Pillar 2 approach is the most appropriate response to operational risk, whereby supervisors would ensure that all firm's have adequate controls and procedures in place to identify and manage such risk. However, if supervisors wish to impose a Pillar 1 charge, the following are our constructive comments regarding the proposed quantitative methodologies.

2.3.1 Definitional Issues

The Basel Committee's definition of operational risk leaves some questions. For instance, there is no guidance on how to interpret the nature and extent of indirect losses. Lack of precise guidance will force banks to interpret the definition of operational risk which will inevitably create inconsistency. Merrill Lynch therefore welcomes the Basel Committee's commitment to work with the industry in refining definitions.

There are further definitional issues in the current proposals. For instance:

- the Basel Committee makes clear that national supervisors should judge whether a particular bank carries significant operational risk, yet has not defined the meaning of 'significant'; and
- the Basel Committee concedes that effective mitigation should, in principle, reduce the capital charge in the Standardised Approach, but has not defined the meaning of 'effective'.

We are similarly confused by what is meant by the terms "near misses, latent losses or contingent losses" and discourage the supervisors from introducing these concepts given the difficulty to define, measure and track them consistently across the industry. For example, firms would have wide latitude in determining "near miss" events. Whether they adopt a narrow or broad definition would likely dramatically affect the resulting capital charge (e.g., for a hurricane that results in no damage, one firm may not report the event whilst another may attribute an average damage cost or "worst case" number).

We would therefore welcome a more detailed description of the Basel Committee's concerns and of the precise nature of the risks the charge is intended to cover. The apparent double-counting of operational risk charges created by the proposed introduction of the *w* factor in the realm of credit mitigation sharpens the need for clarity.

2.3.2 Additional Detail Needed

One of the biggest problems Merrill Lynch has faced in trying to assess the financial impact of the Standardised Approach and the Internal Measurement Approach is that the values of the beta and gamma multipliers which will have to be applied under these methods have not been specified. We have therefore been unable to calculate the size of the charge, nor the extent to which the charge will decrease as we move from the Basic Indicator Approach up the range of sophistication.

Merrill Lynch notes that if a particular bank's risk profile is significantly different from that of the industry (as measured by loss distributions), the capital charge will be adjusted by a multiplier known as the Risk Profile Index. Again, though, neither the term 'significantly different' nor the values of the Risk Profile Index has been defined. We should therefore welcome early definition of the intended approach here.

2.3.3 *The Loss Distribution Approach*

When it is introduced, the Loss Distribution Approach ('LDA') will allow firms to use their internal loss data to translate business lines' distributions of frequency and severity into cumulative loss distributions. The LDA is also a time-tested method, developed over years by the insurance industry to evaluate how much should be charged to mitigate various operational risks. It is superior to the other approaches since it is more sensitive to risk and transparent: in the other approaches, supervisor-determined "alphas", "betas", and "gammas" are based on industry data, which may not be relevant to a firm's unique risk profile. The additional appeal of the LDA is that it is less cumbersome to compute and monitor than the Internal Measurement Approach ('IMA'), which similarly relies on internal loss data. We therefore urge the Basel Committee to introduce this approach at the same time as the other elements of the New Accord.

2.3.4 *The Internal Measurement Approach option needs to be simplified*

Under the proposed IMA, a financial institution with five business lines will most likely be required to organise its data into six loss categories, thereby populating a five-by-six matrix or thirty cells of data. Statistical averages computed for each of these thirty data cells are, in turn, included in discrete formulae that also factor uniquely determined exposure or account activity level. Under this approach, firms will be expected to track both changes in statistical data and activity levels for each of the thirty cells to determine to what extent changes affect the level of capital required.

Whilst the capture of loss category information is useful for management purposes, we question whether it makes sense to introduce this level of complexity in determining the overall minimum supervisory capital requirement. If the justification for this complex approach is because it is more sensitive to risk and transparent, the overriding countervailing argument is that additional variables determined by the supervisors (and the proposed floor) will dilute this effect. Given the limitations of the approach, and the questionable sensitivity to risk, we recommend that the supervisors adopt a simplified IMA currently under discussion by the IIF consortium of banks. This less cumbersome approach would have firms track loss data by business line without dividing the data into loss categories, thereby populating five, rather than thirty, cells to compute the statistical averages that drive the capital formulae. These averages, based on larger populations, will be more statistically valid and easier to monitor, thereby facilitating firms' efforts to adhere and adjust capital requirements as necessary.

2.3.5 *Incentives to Advance*

Merrill Lynch notes that the reduction in the capital charge firms will enjoy when they graduate from the Standardised Approach to the IMA will be limited for at least two years after the New Accord is implemented, that is until 2006. We believe that firms that have qualified for the IMA should gain the full benefit of reduced capital charges immediately, for to do otherwise would dramatically reduce the incentive to meet the entry criteria of the more sophisticated approach.

Since specific numbers were not included in the consultative document, it continues to be unclear how conservatively the Basel Committee will set the various coefficients it must quantify in the IMA formula. These include the gamma term that transforms the expected loss into a capital charge, the exposure indicators, which we understand will be based on "size" without adjustments for better governance and control structures afforded by large firms, and a unique Risk Profile Index applied to each firm. The issue with using very conservative factors, particularly when they are compounded in a formula, is that it can lead both to more formidable barriers for new entrants and the accelerated demise of fallible institutions that might otherwise weather through events which impair capital through loss and require extra capital through their effect on the firm's RPI and/or gamma.

2.3.6 *Flexibility in transitions between stages*

We believe that supervisors should allow firms the flexibility to revert to simpler approaches for several reasons:

- a business lines may change dramatically (e.g. sale of a business, merger, partial liquidation); and
- the cost of conforming to the set of qualifying requirements for a business to adopt a more sophisticated measurement approach may outweigh the benefit.

Successful firms in our industry compete effectively through their agility in transforming themselves in response to changes in market conditions, technology, and consumer behaviour. Firms redirect resources as necessary among new business initiatives and well-established businesses, so there may be times when it is in their interest to advance certain businesses to more sophisticated approaches and pull others back. The new rules should allow firms this latitude.

2.3.7 Exposure Indicators

The Basel Committee's selection of exposure indicators in the Basic Indicator Approach and the Standardised Approach seems arbitrary in as much as we have found no evidence that supports their correlation with operational risk. Certainly, our own experience is that none of the suggested exposure indicators reliably indicates exposure. In this setting, we believe that it is vital the Basel Committee and the EU remain open to the development of true indicators of exposure, and that the capital framework be flexible enough to accommodate them. The use of gross income as an exposure indicator should be viewed strictly as an interim step until better indicators have been developed, and the implementations of the New Accord/CAD3 should remain open to such a refinement.

2.3.8 Linear Function to Determine Charges

Merrill Lynch is concerned that the Basel Committee proposes the use of a linear function of exposure indicators to calculate capital charges under all three methods available initially. We believe that a sub-linear function is intuitively more plausible and, more importantly, is supported by empirical evidence. In our research, we have not been able to identify evidence that demonstrates a one-to-one relationship between activity levels (be they revenues, transaction volume, or client assets) and operational risk loss levels. We are, however, aware of a study prepared last year by PricewaterhouseCoopers ('PwC') which points out several key points:

- size only accounts for a very small portion (about 5%) of the variability in loss severity;
- size of a firm is related to the magnitude of its loss, but the relationship between size of loss and size is not linear; and
- there is clear evidence of a diminishing relationship between the size of a firm and loss magnitude.

PwC concluded that a better fit is obtained by assuming operational risk is proportional to the exposure indicator raised to the power 0.25. We feel strongly that whilst the presently suggested exposure indicators are retained the Basel Committee should reconsider the use of a linear function in the light of a much more extensive calibration exercise.

As supervisors can perhaps appreciate most, institutions that have large and growing levels of activities devote considerable resources toward developing strong governance infrastructures and control environments. These in turn allow management more effectively to contain the level of operational risk incurred vis-à-vis the level of business activity generated.

Merrill Lynch notes that the Basel Committee proposes the use of a simple sum of charges for individual business lines in both the Standardised Approach and the Internal Measurement Approach; the Basel Committee will therefore not recognise the imperfect correlation of losses in separate businesses lines. We urge the Basel Committee to reconsider this point and make allowance for estimates of correlation in the calculation. Perhaps the best way of doing this is to include the Loss Distribution Approach in the New Accord: although we appreciate that the burden of proof is on the industry to convince supervisors that this approach is robust, particularly as implemented in the EU, we urge supervisors to retain the flexibility to include it without the need for further legislation given the length of time the New Accord must remain in place.

2.3.9 Provisional Calibration

Merrill Lynch notes the Basel Committee's caveats about the calibration of beta factors for use in the Standardised Approach, but disagrees with any implied assertion that an average provision of 20% of total economic or supervisory capital or 30% of gross revenue to cover operational risk can be used to calibrate the charge. We also fear that the current calibration was based on a sample that was both far too small and unrepresentative of the population of investment firms. We note that a study sponsored by the Financial Services Authority in the United Kingdom involving investment firms has indicated in many instances even at the lower end of the suggested range of beta factors that the Standardised Approach gives a larger charge than the Basic Indicator Approach, and that many investment firms would have insufficient capital under either approach. As we have discussed, this suggests a wholesale recalibration to a wide population of investment firms is necessary.

The Basel Committee needs to provide additional guidance on how to derive "gross income" (part of the confusion lies in determining what is meant by "net result on financial operations"). Our own informal poll indicates that some banks are basing the number on "net revenues after interest expense" whilst others were basing it on "pre-tax income". The methods diverge substantially, therefore making it very difficult to provide meaningful comparisons and so analytically assess whether the "30%" figure is appropriate. Specific computation examples and the analysis indicating how the "30%" figure is derived would provide the transparency necessary both to understand how to calculate the Basic Indicator Approach charge and whether or not it is at a suitable level.

2.3.10 Disclosure requirements

At this juncture, we believe it better not to develop a list of mandatory disclosure requirements for banks, particularly those that are quantitative in nature. Over the past several years market forces and the formalisation of the operational risk management practice have encouraged firms to discuss the elements of their operational risk management programs in the financial statements. We worry that the insistence on specific statistical information, particularly stemming from loss data, could cause unwitting investors to punish firms that use conservative methodologies to track loss events.

2.4 Credit risk mitigation

Merrill Lynch greatly welcomes the extension of recognised forms of credit risk mitigation, but fears that the proposals are insensitive to risk in certain respects and may inadvertently dramatically reduce liquidity in the repo, stock loan and credit derivatives markets. Each of these markets provides valuable economic benefits, especially the provision of liquidity and the means to transfer risk. Although we appreciate that the Basel Committee must try to anticipate future problems, we ask that the proposals be reconsidered to avoid unnecessary capital burdens.

Of particular concern among the proposals are:

- the permanent haircut *w*; and
- additional haircuts on collateral.

W is puzzling in a number of respects. Although both the New Accord and CAD3 do not explicitly specify the risk *w* is intended to address, it appears from subsequent discussions that the concern is to address "documentation risk". We note, however, that legal risk is included in the operational risk charge, so capital is already to be allocated against this risk class. Even if this were not so, we contend the risk is not large – the market uses standard legal documentation which has been subject to the full rigour of market analysis and practice and shown to have performed well. Although there have been certain well-publicised disagreements in the particular area of credit derivative documentation, they have been settled without full recourse to law, and are, we believe, evidence of a mature and well-functioning market.

The implementation of *w* is also inconsistent. We are puzzled, for example, why bank guarantees are considered to provide better protection than credit derivatives: work commissioned by ISDA suggests credit derivatives are in many ways superior to bank guarantees as protection.

Finally, we fear that *w* may damage rather than enhance the stability of the system: if implemented in their current form, the proposals might well reduce the liquidity of the credit derivatives market, discourage prudent hedging of credit risk, and increase the costs of risk mitigation. Here, as in operational Risk, we believe that a phased approach would be appropriate.

2.4.1 Credit Derivatives and Guarantees

The following comments refer to the Banking Book treatment of credit derivatives and guarantees. We recommend that a separate approach be developed for the Trading Book, and in this regard have been very closely involved in the suggestions set out in ISDA's response.

Merrill Lynch notes that the Basel Committee proposes to maintain the 'substitution approach' of the 1988 Accord - that is banks will be allowed to substitute the risk weight that applies to the guarantor or protection seller for the weight which applies to the underlying obligator. The Basel Committee has stated that the correlation between the default of the underlying obligator and the guarantor/protection seller – both of which must default before the creditor that has bought protection suffers a loss – cannot be quantified accurately. We note, however, that ISDA has developed a simple correlation scheme that will incorporate double incidence of default into the assessment of banks' true risk. Merrill Lynch fully supports this initiative and looks forward to a risk sensitive response by the Basel Committee.

Merrill Lynch welcomes the Basel Committee's proposal to widen the range of eligible guarantors and protection providers to include any corporate rated A or better, but is concerned that a less rigorous standard will apply to sovereign entities, public sector entities and banks. External ratings are homogeneous and imply the same expected loss irrespective of the type of entity and we therefore request that the distinction be removed.

We note that, in order for a credit derivative to receive regulatory capital relief, the credit events specified must, according to the proposal, include certain elements of the "Restructuring" Credit Event (as defined in the 1999 ISDA Credit Derivatives Definitions). Since the restructuring of a loan may not in fact occur without the lender's affirmative agreement, "Failure to Pay" protection (as defined in those Definitions) is the only credit protection that a lender needs in order to lay off the economic risk of a loan. Accordingly, regulatory capital rules should provide regulatory capital relief to loans hedged by a credit derivative containing "Failure to Pay" protection whether or not the derivative also contains "Restructuring" protection. In those cases where, prior to the maturity of a loan hedged by a credit derivative, a lender decides to participate in a restructuring, regulatory capital relief should at that point be adjusted, if necessary, to reflect the lender's new risk position. If the lender's new restructured loan continues to be hedged as before, the lender should continue to receive the same regulatory capital relief on account of the credit derivative. If, on the other hand, the lender's new restructured loan is not in fact hedged by the credit derivative, a regulatory capital adjustment would be appropriate at that point.

We welcome the Basel Committee's approach to asset mismatch whereby protection will be recognised so long as the obligators are the same and the reference asset ranks *pari passu* with, or is more junior than, the underlying claim. We question why "legally effective cross-reference clauses" must apply. It would seem that the focus should not be on cross-reference clauses but on whether a failure to pay with respect to the loan being hedged would trigger a payout under the credit derivative.

Merrill Lynch notes that the Basel Committee proposes to apply the *w* factor to credit derivatives in all approaches to credit risk in the Banking Book apart from the Advanced Internal Ratings Based Approach ('AIRB'). In contrast we note that the Basel Committee proposes not to apply *w* to guarantees issued either by governments or banks. Merrill Lynch is concerned that the protection offered by guarantees is considered superior to that offered by credit derivatives: we are aware that ISDA has commissioned research into the legal status of the protection offered by the two products which concludes that credit derivatives offer protection that is equal if not superior to that of guarantees. Merrill Lynch therefore urges the Basel Committee to eliminate *w*, especially because it drives a wedge between supervisory capital charges and economic risk. Moreover, we note that the Basel Committee has proposed to introduce explicit capital charges for operational risk, a term capturing all risks that *w* is apparently intended to cover; the double counting that this implies increases the size of the wedge.

The Basel Committee suggests under the AIRB firms will assess for themselves the degree to which risk has been transferred, the guaranteed exposure receiving a probability of default appropriate to the guarantor unless the bank itself considers that full substitution is not warranted. We note also that the range of eligible protection providers is not limited and *w* does not apply, at least not explicitly. The requirement for banks to demonstrate that they have considered and prudently assessed the impact of all the residual risks is to be welcomed: such a qualitative assessment, rather than *w*, we believe is a proportionate response to the risk. The quality of firm's controls is, we suggest, best addressed via Pillar 2.

A further source of concern is that a guarantee issued by an insurance company or other corporate is considered inferior to a guarantee issued by a bank of equal or inferior credit rating. This distinction is not substantiated by the market price of protection and we therefore urge the Basel Committee to reconsider.

2.4.2 Parental Guarantees

We are unsure whether the Basel Committee intends to apply the proposals for guarantees outlined in the Standardised Approach to Credit Risk to parental guarantees. The section of the New Accord which stipulates the range of eligible guarantors/protection providers states that '*corporates…including parental guarantees rated A or better*' will be recognised. We have tentatively concluded that this implies that the existence of a parental guarantee allows a subsidiary's counterparties to substitute the parent's rating, and therefore risk weighting, for that of the unrated subsidiary. We support this, and would welcome confirmation.

2.4.3 Collateral

Merrill Lynch applauds the Basel Committee's proposals to widen the definition of eligible collateral to one that is based on collateral which is 'relatively stable' and can be reliably revalued. We are therefore puzzled why other forms of collateral such as exchange traded commodities are excluded. This omission is all the more anomalous given that gold is deemed eligible collateral, as are certain types of commercial and residential real estate under the Foundation Internal Ratings Based Approach. Any freely marketable instrument should be considered eligible collateral, providing appropriate haircuts are maintained.

Merrill Lynch notes that firms will be required frequently to provide a legal opinion on the enforceability of collateral in each affected jurisdiction, and to update this opinion, as frequently as annually. While we support the idea of providing more legal certainty around the enforceability of collateral arrangements, the process of procuring and updating opinions may be very expensive in both time and money, so careful consideration must be given to the requirement for opinions and updates in all cases. We note that there have been significant developments in the area of collateral agreements resulting in standard forms being used for many types of transactions, in particular for OTC derivatives, for which no separate legal opinion is obtained or has been expected. These forms have been produced with various industry groups' sponsorship and based on extensive legal analysis, and are backed up in many cases by formal legal opinions. We would pose the question as to whether legal opinions are needed if such standard forms of collateral agreements are used and would propose that collateral covered by these types of agreements should be exempted from the requirement. In the case of collateral arrangements where there is no standardised agreement, it is not clear why frequent updates of legal opinions are necessary or provide additional legal protection in light of the cost of implementing such a procedure. Finally, we would assume that legal opinions, as used in this section, would include opinions delivered by in-house or internal legal counsel, as well as external legal counsel , but would appreciate clarification on this point.

While we question the value of updates of opinions with any type of mandated frequency as briefly outline above, if these opinions are to be required, we would request that opinions delivered by internal lawyers or in-house counsel should be recognised.

Merrill Lynch finds the haircut to cover volatility of the underlying exposure, H_E, problematic for two reasons:

- the treatment is inconsistent between assets that are marked to market and assets that are accrued; and
- OTC derivatives are already subject to an allowance for potential future credit exposure, so there is an element of double counting.

The Basel Committee has yet to set the level of *w* for transactions collateralised by cash. We feel strongly that *w* should be zero for all transactions.

2.4.4 On-balance Sheet Netting

Merrill Lynch notes that the Basel Committee proposes to recognise netting of loans and deposits (only) of a single counterparty (only) in the Banking Book. We note also that a portfolio of loans and assets with the same counterparty must be decomposed and netted individually. The exclusion of other types of asset and liability is puzzling, as is the exclusion of group accounts in the presence of a robust netting opinion.

2.4.5 Offset of Specific Risk in the Trading Book

Merrill Lynch notes the Basel Committee's proposals on the netting of specific risk in the Trading Book. An 80% offset is suggested for positions that are hedged by credit derivatives, but only if the reference asset, maturity and currency of denomination match the underlying exposure. Given the very good hedges offered by positions in one instrument against those in another of the same obligator and seniority, we believe that the proposed offset is too low, and the requirements for matching are unnecessarily restrictive. We are therefore working closely with ISDA to quantify the extent of hedging specific risk in a wide range of circumstances. This is an important subject whose resolution could change the incentives for proper management of specific risk, so we suggest that supervisors engage in dialogue with the industry on this topic.

2.4.6 Netting off-balance sheet and on-balance sheet exposures

Merrill Lynch notes that the Basel Committee will continue not to recognise the netting of on-balance sheet exposures with off-balance sheet exposures. We accept that the types of exposure are not fully homogeneous, but would recommend that the Basel Committee allow some offset.

2.4.7 Stock lending and repos

The New Accord refers to the retention of the Banking Book treatment of stock loans and repos. What particularly concerns Merrill Lynch is the suggestion that the same treatment will be carried over to the Trading Book. This understanding has arisen following discussions and correspondence between LIBA and FSA. We disagree with this proposal and believe the fundamental difference between the Trading and Banking Books should be retained. It is difficult to understand why supervisors would contemplate replacing a Trading Book approach (i.e. the current EU regime) that works satisfactorily with something designed for the Banking Book. To illustrate the impact of the proposals on these transactions we have included some example calculations in Appendix 1 "Impact on stock lending and repo transactions".

In effect the carry across of the proposals would require *w* and haircuts to be applied to the collateral leg of financings, where neither is presently taken. This would cause a significant increase in regulatory capital, and detrimentally affect the repo market, the key source of short-term liquidity for many institutions. We believe that any significant constraint on this market may increase systemic risk in the system as a whole.

LIBA/BBA/ISDA[3] have been very active in developing proposals for a slightly revised Trading Book treatment for these types of transaction. We have fully participated in this work. Whilst we do not believe, in the interim, that the present EU Trading Book treatment should be changed (and consequently that it should be adopted by the Basel Committee), we do consider the trade associations' proposed treatment to be a basis for discussion in the much needed debate on the Trading Book in general and securities financing transactions in particular.

[3] Refer to ISDA/LIBA/BBA's respective responses for details of this proposed treatment.

2.4.8 *Internal haircut estimates*

The requirement that only banks that have received supervisory recognition for an internal market risk model will be allowed to estimate haircuts seems to be unduly harsh. We believe that a more flexible approach to permissions to use own estimates for collateral haircuts would be better. The methodologies used by individual institutions should be subject to regulatory review and approval but should be judged on individual merits and past bad debt experience which in itself would demonstrate the effectiveness of the method adopted.

2.5 Market discipline

Merrill Lynch agrees with the underlying philosophy of Pillar 3, but we are concerned that the proposals may be onerous to prepare, are not appropriately targeted and may lead to the unnecessary publication of proprietary information. We support the proposals and progressive approach to disclosure outlined in the Shipley Report[4]. In outline the proposals in the New Accord are not dissimilar to those highlighted in the Shipley Report. However we feel that the detailed disclosures extend the disclosure requirements well beyond those recommended in the Shipley Report.

2.5.1 *Coherence*

The prescribed disclosures do not seem to be underpinned by a coherent approach and philosophy – they have been described as a "scattergun" approach. We therefore feel that some of the disclosures will not be readily understandable to all but the most dedicated and diligent researchers, and may actually obscure the real story and confuse the lay reader.

2.5.2 *Important proposals*

Merrill Lynch agrees with the underlying principle of Pillar 3, that is, using the market to discipline firms based on the disclosure of relevant information. In theory an efficient and strongly controlled organisation should have nothing to fear from the application of this concept, but we feel that in some circumstances the current proposals could be inappropriate, onerous to publish, and may give rise to misunderstandings.

2.5.3 *Proprietary Information*

There is a key distinction between information to be publicly disclosed and that to be shared between a firm and its supervisor. We believe that existing detailed bilateral disclosures should continue, but public disclosure should not dilute a firm's competitive advantages. For example, if information is publicly disclosed that shows that a firm has significant credit risk exposure and will require short term funding, then it is unlikely that the firm will be able to obtain a favourable funding rate as a result of this exposure. If this related to a firm that was not in control of its credit risk then market discipline would be seen to be working, but if this risk resulted from a fully collateralised transaction, the market's conclusion would be erroneous and damaging to the firm. Note, for instance, that this could occur where, due to the treatment of collateral envisaged elsewhere in the proposals, the exposure for supervisory purposes was not zero despite being fully collateralised from the perspective of market convention. In this case, a firm might feel obliged to explain the discrepancy in credit risk, but in doing so may need to disclose further proprietary information.

2.5.4 *The right incentive*

We support the concept that a firm's willingness to disclose market sensitive information should be rewarded with lower regulatory capital, but the reverse of this does not necessarily follow. The IRB approach will not inevitably lower regulatory capital, and without this reduction the higher cost of compliance caused by disclosure will hinder the passage of firms into the IRB approach. This may in turn stall the "improvement in risk management techniques" that the Basel Committee is striving for. This is pertinent for investment firms (and banks with large Trading Books) given the potential impact of the credit risk mitigation proposals discussed elsewhere in our response.

We also remain unconvinced with the suggestion that Pillar 3 allows the passing of supervisory responsibility from the supervisor to the market: this would create the wrong incentives. This is particularly important in relation to the IRB approach. It is for the supervisor to determine the ability and preparedness of a firm to undertake the IRB approach –

[4] "Working Group on Public Disclosure" report, dated 11 January 2001, to the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency and US Securities and Exchange Commission.

this requires detailed interpretation of largely qualitative information. The market can only interpret the information provided by firms. The market's response to adverse information is a withholding of business or increase in cost of funding, as well as a decrease in market capitalisation. A more subtle response may by needed and only the supervisor can supply this finesse.

2.5.5 Means of disclosure

It is not clear where the proposed disclosures are to be made. The frequency of some of the requirements seems to preclude the use of financial statements, but no alternative has been suggested. If the intended audience is banking analysts, then the financial statements need not be used and another vehicle could be found, possibly using the existing communication channels. We have given some thought to this issue of alternative routes for disclosure, and concluded that a suitable alternative would resemble the FSA's (ex-DTI) insurance forms or the SEC's Form 10-K, both of which are publicly available and used by analysts. This approach has the benefit of making the information available to the analysts (the primary targets of Pillar 3) and the wider public, and a further benefit in avoiding cluttering the financial statements with detailed disclosures. The supervisors could disseminate these forms, possibly via the Internet. The public forms should not be the same as the supervisory returns, as necessarily the latter will always contain significantly greater detail.

The use of financial statements (or other public documents) to disclose additional regulatory information will give rise to the potential for misunderstanding. This concern is best illustrated by the use of examples. Readers may not appreciate the subtle differences between the three types of capital information they will be presented with – accounting, regulatory and economic. Also, a reader may have no sense for what constitutes an appropriate capital buffer and so incorrectly decide that it is too risky to deal with a firm (or invest in it) as it is on the edge of being capitally unsound. At the very least these concerns highlight a need for the financial community, and especially the supervisors, to educate the public.

2.5.6 Legal entity disclosure

The proposals currently require disclosure at the legal entity level. The extent and level of disclosures would mean that this would be an onerous exercise for complex groups. At the legal entity level some of the disclosures may even be misleading due to the existence of inter-company balances and transactions. Our analysts suggest that only information at the group (or significant sub-group) level will be useful and widely used, especially given the preponderance of parental guarantees of operating subsidiaries. We therefore suggest that disclosure be confined to the parent of financial groups.

2.5.7 Accounting Standards

We are concerned by the apparent lack of co-ordination between the Basel Committee and IASB, and very much welcome recent promises of mutual co-operation. Indeed, since the IASB is currently reviewing the disclosure requirements for banks (International Accounting Standard 30, 'IAS30'), the time is ripe for the Basel Committee to liaise closely in the production of a single set of disclosure requirements. Even if financial statements are not to be used for Pillar 3 disclosure, it is vital that the regulatory requirements are prepared in concert with IAS 30, so as to minimise overlap, improve consistency and reduce the cost of implementation. It is also important that the Basel Committee gives some thought to the application of International Accounting Standards as not all jurisdictions follow them.

In this context, we note that in April 2000 the Basel Committee's Report to the G7 Finance Ministers and Central Bank Governors reviewed the International Accounting Standards that had a significant effect on banks. Essentially the Basel Committee concluded that it had particular concerns with IAS 30, primarily being that it has not been updated since 1991 and its consequent failure "to encompass current best practice in terms of disclosure of risk exposures and risk management policies". This phrase seems to suggest that current best practice for disclosures was accepted by the Basel Committee and that it merely wished to see that best practice codified in a revised IAS30. It has therefore been troubling to find that the Basel Committee is now proposing an increase in disclosures in excess of current best practice or the requirements of IAS, UK GAAP or US GAAP.

We note also the International Accounting Standards Committee's Framework that states that there are four principal characteristics of information in financial statements that make that information useful to users. The four characteristics are:

- understandability;
- relevance;
- reliability; and
- comparability.

In our view the proposed disclosures fail both the understandability and relevance tests.

2.6 Consolidated supervision

Under CAD3, it is proposed that the current consolidation waiver regime will not be adopted for firms that hold client money. Given that client assets are held in segregated accounts, we do not believe where there is a strong national supervisor with sound customer protection rules and regulations, that consolidated supervision is necessarily required. We believe that there is a strong case for national supervisors to retain the right to grant a waiver from full consolidation where they believe that the circumstances merit it.

Moreover, we note that the Investment Company Institute has voiced concerns to the Basel Committee on the topic of consolidation of investment firms.

3 Other matters

3.1 Legislative flexibility

Merrill Lynch believes that it is imperative to ensure that the enabling legislation for the New Accord allows for a flexible development. The rapid changes in the market place, together with the incomplete nature of some of the proposals, make this important. It would be unfortunate for consumers, firms and supervisors if the detail of the New Accord were to remain unchanged for another 10 years. The Basel Committee should therefore plan to revisit the New Accord frequently: moreover, the EU should implement the New Accord via a legislative process that allows widely accepted revisions to be enacted (in the context, of course, of appropriate Parliamentary scrutiny of the core principles of the Directive).

3.2 Pillar 2

Merrill Lynch supports the proposals outlined in Pillar 2. We note that a large part of these proposals will be left to interpretation and implementation by local supervisors, and in this context it is important that a level playing field is retained. We suggest below how disclosure by supervisors could mitigate these concerns.

The application of Pillar 2 will require supervisors to be continually mindful of market developments just as Pillar 1 requires that they be mindful of developments in risk management and allow these to become incorporated into capital requirements as they reach fruition. Otherwise, Pillar 1 risks becoming obsolete as practices develop. If Pillar 1 represented a truly *de minimis* capital charge and supervisors were flexible in the interpretation of Pillar 2, this would mitigate this concern. However, as currently constituted, Pillar 1 results in charges considerably higher than economic capital models indicate, and is framed much more prescriptively than economic capital practice. Moreover, Pillar 2, as currently framed, can only increase capital. Given that Pillar 1 does not reflect *minimum* capital requirements, and that market developments will only serve to accentuate this, we believe that the application of discretion in Pillar 2 should be capable of decreasing as well as increasing overall capital.

3.3 Definition of Capital: Goodwill

In general we support the Basel Committee's decision not to revisit the definition of capital contained in its 1988 deliberations. However there is one area where we do believe that action is necessary, and this concerns goodwill. Recent proposed changes in US GAAP have changed goodwill from an amortising asset into a permanent one subject to an impairment test. This change gives recognition to the fact that goodwill has inherent economic value and is not by definition a wasting asset. Whilst we realise such assets are illiquid, we nevertheless believe that it is unnecessarily penal for them to be subject to a 100% deduction from capital, especially given that this severity of treatment could prevent acquisitions which strengthen the overall financial system. We would encourage the Basel Committee to enter into a debate about the appropriate haircut for goodwill and criteria for determining impairment.

3.4 Supervisor transparency

Many supervisors have recently stated that they view Pillar 3 as an integral means of ensuring level playing fields. We agree, and would add that there is a strong case for extending the disclosure requirements to supervisors to allow ready comparison of different regimes. We therefore consider it important for supervisors to disclose details of their supervisory approach, both in terms of policy and details of implementation. The population of firms having capital charges above the minimum (e.g. the percentage of firms with capital requirements between 8% and 9%, 9% and 10%, etc.) should be disclosed. This disclosure would provide a strong incentive to ensure level playing fields.

Appendix 1 Impact on stock lending and repo transactions

The examples below highlight the impact on capital charges of the proposed collateralised transaction rules, if applied to trading book repo / stock lending activity.

Example (1): Corporate bond repo

Merrill Lynch lends A rated 3 year maturity corporate bonds of MV $510m (a 6% haircut under the proposals), and receives $500m cash collateral (a 0% haircut under the proposals). Transaction is documented under a legally enforceable industry standard master agreement, with daily revaluation and margining clauses.

From Merrill Lynch's perspective the impact on capital is as follows:

Current CAD treatment: $10m credit exposure. Assuming counterparty is 20% risk weighted bank, the counterparty risk capital requirement is $160k.

The New Accord treatment: Value of collateral after haircut = $471.7m. Adjusted value of collateral after 15% "w" = $400.94m. Adjusted exposure is $109.06m, giving a counterparty risk capital requirement of $1.74m. Increase of $1.58m.

Note: In the example above if the eligible bonds were replaced with ineligible equity, it is unclear what value of H_E would be included in the calculation – ineligible stocks do not appear in the standard haircut table. To use a value of 100% (and so in effect disregard the collateral) would be totally unrealistic as, in the example, Merrill Lynch would be holding cash collateral in excess of the value of the equity.

Example (2): Stock lending

Merrill Lynch lends equities (MV $700m) and receives equities as collateral (MV $880m). The transaction is 126% over-collateralised, subject to daily revaluation and re-margining, and is documented under a standard industry master agreement. The equities lent are listed on a recognised exchange (30% haircut under the proposals) and the collateral received is listed on a main index (20% haircut under the proposals). The collateral received is of a higher quality than the stock lent; there is a high degree of positive correlation.

From Merrill Lynch's perspective the impact on capital is as follows:

Current CAD treatment: Zero counterparty risk capital requirement; the transaction is over-collateralised and meets documentation, valuation and margining standards.

The New Accord treatment:

Gross exposure		$700m
Market value of collateral	$880m	
Total haircuts: 20%+30% = 50%		
Collateral value after haircuts ($880m/1.5)	$586.67	
Adjusted Collateral Value ($586.67m*(1-0.15))		($498.67m)
Adjusted Exposure		$201.33m

Assuming a 100% weighted counterparty, counterparty risk capital requirement of $16.1m.

Example (3): Portfolio of Bond Repos / reverse repos

As a result of a series of transactions with the same counterparty, Merrill Lynch has lent total bonds of MV$130m (an assumed 4% haircut under the proposals) to a professional market counterparty against $99m cash collateral (a 0%

haircut under the proposals), and additionally borrowed total bonds of MV$132m (an assumed 4% haircut under the proposals) from that same counterparty, posting $101m cash collateral (a 0% haircut under the proposals). Remargining occurs, and additional cash or securities are posted daily to maintain a "flat" exposure.

The bonds are bank issued, AAA/AA rated, with 1-5 years residual maturity. There is a legally enforceable netting arrangement; in the event of non-performance by either party, all exposures and collateral may be netted. There is a high degree of correlation between the bonds.

This portfolio of trades can be summarised as follows:

Exposure			**Collateral**		
Instrument	*H'cut*	*MV*	*Instrument*	*H'cut*	*MV*
Cash	0%	$101m	Bank securities	4%	$132m
Bank securities	4%	$130m	Cash	0%	$99m
		$231m			**$231m**

From Merrill Lynch's perspective the impact on capital is as follows:

Current CAD treatment: Zero counterparty risk capital requirement. The portfolio is fully collateralised, and meets netting, documentation, valuation and margining standards.

The New Accord treatment: Haircuts applied appropriate to collateral and exposure instruments. The adjusted value of the collateral is $220.95m (see Note below). Additionally apply "w" of 15%, reducing value of collateral to $187.81m. The adjusted exposure is $43.19m. If the counterparty is weighted at 20%, the counterparty risk capital requirement is $691k.

Note: The precise methodology for applying netting to portfolios of repos / reverse repos is not clear from the New Accord proposals. In the example above, each collateral item has been reduced by the appropriate value (0% to $99m and 4% to $132m). The collateral has then had an exposure haircut applied. This is a weighted average, calculated as follows:
[(0%$101m)+(4%*$130m)]/$231m = 2.25%.*

Appendix 2 Responses to the questions posed by the European Commission

Scope of Consolidation

Do you support the proposed treatment of the waiver issue in general? If not please identify specific points of concern and provide preferred amendments.

Merrill Lynch response: We do not agree with the proposed treatment. Our concerns are summarised in section 2.6 “Consolidated supervision” of the main body of our response.

In particular do you support the need for a special treatment for investment firms with respect to consolidated supervision, based on a higher degree of flexibility (i.e. having additional options as regards, for instance, the identification of the holding company of the group, the entities belonging to the group, and the supervisory regime, with particular regard to capital adequacy rules)?

Merrill Lynch response: We support the need for flexible interpretation, especially with regards the interpretation of the holding company of the group. In many instances, the legal holding company is merely a by-product of legally-driven structures, does not form part of the operating group and does not trade in its own right.

Internal Ratings Based Approaches

Please indicate if you do not support the proposals put forward by the Basel Committee in respect of the Internal Ratings Based Approaches. If there are elements of these proposals that you do not support, please provide specific details.

Merrill Lynch response: In general we support the underlying approach of the proposals put forward by the Basel Committee. However we do have particular issues with the carry across of the credit risk in the Banking Book proposals to Trading Book counterparty risk, in particular the approach to credit risk mitigation. Our concerns are detailed in section 2.2 “Impact on Investment firms” and section 2.4.6 “Stock lending and repos”. Also, we refer the reader to the detailed comments in the ISDA and BBA/LIBA formal responses. We support these comments.

Do you support the proposed risk weights for corporate, sovereign and bank exposures on the basis of a reference asset with a 0,7% PD, a 50% LGD and a 3 year maturity? Views different from the proposals should be underpinned with statistically meaningful internal economic capital allocation data.

Merrill Lynch response: In this respect we refer the reader to the detailed comments in the ISDA and BBA/LIBA formal responses. We support these comments. In particular the large capital charge required on the lower rated assets compared to the standardised approach may create disincentives and foster inappropriate behaviour.

Regarding the Basel rules in respect of the adoption of the IRB approach across exposure types and business units: Do you support an additional exemption for not material exposures in terms of size and perceived risk profile? Please provide specific details.

Merrill Lynch response: We support the materiality exemption, but ask that guidance be provided on the definition and practical interpretation of materiality. Materiality should not just be based on the size of the exposure or charge, but also on cost/benefit considerations. Forcing firms to apply IRB to ‘large’ exposure types that occur infrequently might not be appropriate.

Do you support the proposed modifications of the Basel rule regarding an annual internal audit of banks' rating system?

Merrill Lynch response: We support the need for internal audit review of banks' rating systems as we regard this as 'good practice'. However, to require an annual audit is an unnecessary intrusion on the independence of internal audit's determination of its own work programme based on their assessment of the balance of the risks to the firm.

Please indicate if you do not support the proposals regarding the pooling of data for estimation of PD.

Merrill Lynch response: We support the pooling proposals.

Do you support the proposals in respect of market discipline in the context of the IRB approach? In particular, consumer representatives and users of financial statements as well as credit institutions and investment firms are invited to provide detailed views on issues raised by greater disclosure they do not support.

Merrill Lynch response: Our detailed comments are provided in section 2.5 "Market discipline".

Revised Standardised Approach

Please indicate if you do not support the proposals put forward by the Basel Committee in respect of the Revised Standardised Approach. If there are elements of these proposals that you do not support, please provide specific details.

Merrill Lynch response: We support the proposals.

Which of the two options in respect of the treatment of credit institutions and investment firms do you favour:
a) based on the external credit assessment of the sovereign of incorporation
b) based on the external credit assessment of the institution itself, where such a rating exists.
Please offer reasons for your preference and bear in mind that under the second option, an absence of an external credit assessment for an institution will mean that a standard risk weighting of 50% will apply.

Merrill Lynch response: The second option is more consistent with a risk sensitivity approach as it looks at the institution itself rather than the country of incorporation. There are many examples of non-state owned banks whose geographic risk profile is very different from its country of incorporation. We also feel it is appropriate to note that some commentators have questioned the validity of the first option in the EU as it is deemed to be "contrary to the Treaty of Rome".

Do you support the application of a risk weighting of 150% to asset items that are 60 days past due, net of specific provisions? If you do not support this proposal, please provide reasons.

Merrill Lynch response: We support this proposal, and note an area of level playing field concern in that investment firms are not allowed to offset provisions. We would welcome the introduction of a cap or "discount" to take account of this restriction.

Credit Risk Mitigation and Securitisation

Please indicate if you do not support the proposals put forward by the Basel Committee in respect of Credit Risk Mitigation. If there are elements of these proposals that you do not support, please provide specific details.

Merrill Lynch response: We have concerns about the potential for the carry-across of these proposals to the Trading Book. This is fully articulated in sections 2.2 "Impact on investment firms" and 2.4.7 "Stock lending and repos".

Large Exposures

Please provide any specific recommendations on elements of the Large Exposures regime that should be amended to ensure consistency with the solvency regime.

Merrill Lynch response: Our response to this question largely depends on the final Trading Book treatment of stock lending and repos. If the Banking Book treatment is to be applied, then the large exposure regime will considerably magnify the impact.

Other Risks (interest rate risk and operational risk)

Please indicate if you do not support the proposals put forward by the Basel Committee in respect of the Interest rate risk framework. If there are elements of these proposals that you do not support, please provide specific details.

Merrill Lynch response: The Basel Committee recommendation in Annex 2 of the Interest Risk paper suggested that one approach may be to set up a reporting framework to enable the supervisors to carry out their own analysis of interest rate risk. We believe that the supervisors should be prepared to review existing reports from institutions own risk management functions. To set up a standardised framework would only increase the reporting burden and would not necessarily be consistent with the methodologies adopted by management, therefore not adding value to the control mechanisms already in place.

With regard to Principle 13 on disclosure, we believe that allowing market participants access to key information on the Risk Management process does not strike the right balance between "reasonable investor" disclosure and the publication of proprietary information.

Do you think that it would be better not to include some accounting categories listed in tables 1 and 2 of Annex 1 in the scope of the interest rate risk framework?

Merrill Lynch response: We do not support the inclusion of undrawn committed loan facilities in the scope of the interest rate risk framework.

Do you support the intention of making the standardised approach for operational risk accessible to a wider range of institutions on the basis of reasonable risk management standards? Specific suggestions **-** *drawing from the industry's best practice of risk management standards* **-** *are welcome.*

Merrill Lynch response: We believe that institutions should be free to choose whichever approach they believe is appropriate for them subject to their meeting the required qualitative standards. The main rationale for this point of view is that cost to firms of conspicuously complying with required standards of operational risk management will be significant and will have to be compared with potential benefits. As for the standardised approach, we have considered the proposals and believe that this approach is barely more sensitive to operational risk than the basic indicator approach; both approaches seem only to provide an arbitrary capital buffer to augment other elements of regulatory capital and to bear little if any relationship to operational risk. We therefore see no reason why any firm should be arbitrarily prevented from using it.

Do you find the provisional calibration of the standardised approach as presented in the Basel Supporting document on operational risk relevant in the EU context? Input from federations of small and/or specialised institutions is specifically sought. Comments on the relative weightings of business lines (see table 1 of annex 3 of the Basel Supporting document) and the preliminary betas (see annex 3 of the Basel Supporting document) are specifically invited. Numerical evidence of the impact on specific industries will be most welcome.

Merrill Lynch response: We are concerned with the calibration of the Standardised Approach for several reasons. First, the calibration has been based on the assumption that operational risk charges amount to 20 % of overall minimum regulatory capital. This assumption is unrealistic, for the amount concerned is far greater than most firms' estimates of economic risk arising from this source.

The second major source of our concern is that the calibration has been devised with (internationally active) banks in mind; the proposed new legislation in the EU, however, will also apply to investment firms. Given the diversity of activities across the whole community to which the Accord will apply, we urge both the Basel Committee and the European Commission to ensure that the calibration of charges is relevant for this whole community.

Our final concern is that the calibration is based on 'preliminary analysis' that has yielded wide ranges of values for the beta factors. We have therefore been unable to quantify the impact on our business to an acceptable degree of accuracy. At the moment, we cannot even conclude that the standardised approach has been calibrated to yield lower charges than the 'less sophisticated' basic indicator approach. A great deal of work remains to refine the calibration and with such a short consultation period we fear that the final results will appear too late for the industry to plan appropriately for the impending change.

Do you support the intention of developing a spectrum of internal-based methodologies for operational risk in the future, to facilitate the transition from the standardised approach to more sophisticated methodologies?

Merrill Lynch response: Our comments on this question are fully articulated in section 2.3 "Operational risk". From our reading of the proposals it seems that the 'spectrum' of approaches is in no way continuous, but a staircase requiring large discrete jumps to advance. What we do not understand, however, is how large these jumps are. We would therefore welcome any development that would sensibly control the marginal cost of progress and makes obvious the steps to be followed. We would also welcome clarification of the standards firms will have to meet before they will be allowed to advance to the most sophisticated methodologies.

As we have already suggested in an answer to a previous question, firms will compare the costs of graduating to more sophisticated approaches with the potential (cost of) capital savings they will bring. For the system to work, the various approaches must be calibrated to provide firms with adequate incentives - after increased costs of advancing have been recognised - to advance along the spectrum. We therefore consider the proposed implementation of 'Floors' which restrict the savings in capital to be undesirable and an artificial constraint on the risk sensitivity of the New Accord.

What risk mitigation techniques (other than mandatory professional liability insurance) do you think deserve recognition under the standardised approach for operational risk? Please specify what qualifying criteria such techniques should meet (legal robustness, timeliness of payments…) and how the risk mitigating effect could be factored in the standardised approach.

Merrill Lynch response: These matters are fully articulated in the responses of the trade associations, but in summary insurance and outsourcing under a robust Service Level Agreement should be recognised as valid risk mitigation techniques.

Trading Book Issues

Please comment on whether you perceive a need for specific additional guidance on the allocation of items between the TB and the BB. From an EU perspective, the following areas will be covered, with a view to delivering a sound and prudent approach and favouring harmonisation: internal deals and internal hedges; switching of items between portfolios; treatment of specific instruments and techniques (notably credit derivatives, CIU and ETF). Are there other specific areas where a higher degree of harmonisation would be useful?

Merrill Lynch response: We believe the proposed guidance delivers the right balance between setting defining standards and providing a degree of prudent flexibility.

Do you support the proposal to drop the reference to a "list" of financial instruments for the purposes of regulation on capital? Is there a need for additional mechanisms to facilitate a common approach as regards the definition of financial instrument?

Merrill Lynch response: We support the proposal to drop reference to a list, and do not believe additional mechanisms are necessary.

Please indicate whether you support the need to review the practices governing institutions' allocation of items between the two books at the end of an appropriate observation period, and to consider the need for further amendments regarding this aspect on the basis of the results.

Merrill Lynch response: The formal observation period will not be needed if the EU adopts a flexible legislative process.

Please indicate whether you see a need to revisit the EU regulatory framework for market risk - beyond the proposals presented by Basel – with a view to addressing the inconsistencies noted when comparing the proposed amendments to the banking book treatment with the unchanged trading book treatment.

Merrill Lynch response: We consider that it is essential that market risk is revisited to ensure that investment firms remain on a competitive footing with credit institutions. We wholeheartedly welcome the suggestion in this question that the Trading Book will remain "unchanged". A very sizeable part of our response is devoted to explaining why the Trading Book should largely remain unchanged, and so we support this approach.

Supervisory Review Process

Please indicate if you do not support the proposals put forward by the Basel Committee or by the Commission Services in respect of the Supervisory Review Process. If you do not support these proposals, please identify the specific aspects of concern.

Merrill Lynch response: We do not have any significant concerns with the proposals, but wish to ensure that level playing field issues are minimised. As the corollary to Pillars 2 and 3 we believe that it is important that supervisors disclose information about the adoption of the proposals by the entities in their charge, especially in areas involving supervisory approval or choice.

Market Discipline

Do you agree that the most effective way of ensuring that institutions adhere to disclosure requirements, and with a view to maintaining the level playing field, is to provide in a directive for core disclosure requirements? If you do not support this approach, please identify the specific aspects of concern.

Merrill Lynch response: Our concerns in this area are articulated in section 2.5 "Market discipline".

Do you agree that the arguments against publication of supervisory capital ratios outweigh the argument in favour and that publication of this ratio be prohibited, having regard, of course, to the requirement that institutions will be obliged to publish their capital ratio calculated in accordance with the directives? If you do not support this view, please identify the specific aspects of concern.

Merrill Lynch response: To help police the level playing field concerns, we believe that capital ratios should be published, not by individual entities but in summary form by the supervisors.

Do you agree that sufficient attention has been given to ensure that disclosure requirements are proportionate to the nature and scale of the institutions concerned? If you do not agree, please specify details.

Merrill Lynch response: We do not believe that sufficient attention has been given, and our concerns are articulated in section 2.5 “Market discipline”.

Is there agreement that the areas requiring disclosure have been adequately covered? If not, please provide specific details.

Merrill Lynch response: Our concerns in this area are articulated in section 2.5 “Market discipline”.