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State Street Corporation
Comment Letter
New Basel Capital Accord
May 2001

Executive Summary
For General Use

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Executive Summary

State Street Corporation is a financial holding company organized under the laws of the Commonwealth of Massachusetts in the United States of America and is one of the leading specialists in serving the world's investors. State Street provides a full range of products and services for portfolios of investment assets. State Street Bank and Trust Company, the principal subsidiary of the holding company, operates under a Massachusetts charter and is a member of the U.S. Federal Reserve System.

State Street supports the new accord's objective to create a more risk-sensitive and flexible capital adequacy framework. We will continue to participate in industry discussion and dialogue in support of ongoing development and definition of specific aspects of the new accord.

Our greatest concern with the accord arises from the proposed capital treatment of operational risk. State Street strongly recommends that operational risk is most appropriately a Pillar 2 consideration and should not be a Pillar 1 regulatory capital requirement. It is also our strong belief that the introduction of a Pillar 1 requirement will have serious negative impacts on the global financial system and market participants. Specifically:

- The introduction of an operational risk capital charge will create an uneven playing field and increase the business and strategic risk of companies governed by the accord. It will also introduce uncertainties and systemic risks in global markets by changing the behavior of all competitors in undesirable ways.

  Non-bank competitors will attempt to take advantage of their improved position, which will be detrimental to the profitability of participants who are subjected to the proposed operational risk capital charge. Institutions governed by the accord will attempt to arbitrage the regulatory framework and seek to organize outside of the accord's reach, thereby moving activities to entities not conforming with risk management control, and safety and soundness principles of the banking industry. Furthermore, the capital charge will inject risks into the system by causing industry participants to make capital-reducing but unsound business, risk-taking, and risk management decisions.

- The lack of an even playing field extends beyond regulatory arbitrage. The vastly different legal, accounting, and regulatory/supervisory infrastructures across national jurisdictions make the application of an equitable capital charge difficult to achieve. This has serious potential to distort the relative competitive positions of firms.

- These issues are further exacerbated by the fact that quantification methodologies for operational risk are in the early stages of development. Emerging methodologies are primarily theoretical in nature and are untested due to the lack of data. As a result, there is a strong likelihood that the implementation of an operational risk capital charge will result in inaccurate and overstated capital requirements. Indeed, our analysis of our extensive database of operational losses supports this conclusion.

Implementing a Pillar 2 supervisory treatment will offer the industry and regulators the opportunity to address more adequately issues pertaining to ensuring a level playing field for all competitors across jurisdictions and regulatory boundaries, as well as to minimize potential structural and systemic dislocations in financial markets. It will also allow the industry and the regulators the opportunity to work further on risk definition, data collection, and quantification methodologies, and to study the potential impact of a capital charge.

Notwithstanding the foregoing, State Street is prepared to assist the committee in developing a comprehensive capital adequacy framework to accomplish the new accord's stated objectives. The pages that follow represent our views, observations and recommendations on specific aspects of the new accord focused on credit risk, operational risk and Pillar 3 disclosure requirements.

Credit Risk

State Street supports the development of a risk-sensitive approach to calculating risk-based capital for credit risk. We also support the recognition of credit risk mitigation, such as collateral and credit derivatives, and the expanded categories of risk weights to increase the risk sensitivity of the capital assessment methodology.

Our comments largely focus on our key business activities that will be impacted by the proposed changes in capital treatment. These key business activities are short-term credit commitments, securitization and securities lending.

Short-Term Credit Commitments

We propose that risk weights lower than 20% should be used for liquidity facilities that are drawn infrequently, supported by high quality assets and have a low probability of loss. We also propose that the capital requirements for short-term commitments be phased in over a multi-year period.

Securitization

State Street is active in providing credit and liquidity enhancement support to securitization transactions originated by other financial institutions and as a sponsor of asset-backed commercial paper conduits. For these types of transactions, we suggest that the committee should consider finer rating gradations and a more gradual increase in capital charges at each gradation level than those proposed in the new accord.

Securities Lending

We support the recognition of credit mitigation, an area of major improvement in the new accord, particularly regarding collateralized credit transactions. However, in the treatment of collateral, we are concerned about the inclusion of the *w* factor as a risk weight to capture certain less quantifiable risks and to serve as a floor for capital requirements. The *w* factor double-counts loan and collateral liquidity risk already captured in the haircut treatment. In addition, while we strongly propose Pillar 2 treatment for operational risk, as a conceptual point, however, the *w* factor also double-counts elements included in the proposed accord's definition of operational risk, such as legal and documentary errors.

In the event the committee requires the application of the *w* factor, we propose that the criteria for those transactions (i.e., repo-style transactions) that qualify for *w*=0 be expanded to encompass all securities lending transactions that comply with the key qualifying criteria. We suggest that a securities lending transaction should enjoy w=0 capital treatment to the extent that it is governed by well-established legal documentation, is rigorously marked-to-market and remargined on a daily basis, is settled across an established settlement system and is subject to the appropriate haircuts.

Furthermore, we recommend that credit risk be measured by incorporating the effect of diversification and covariance. For example, the credit risk in securities lending transactions with a securities broker-dealer should be measured at the portfolio level rather than at the transaction level. The portfolio measurement methodology recognizes that the movement in the value of certain security loans and collateral types may be offset by the movement of other securities within the portfolio. In this regard, it is the net claim to the counterparty that reflects the credit risk facing the lender.

The new accord proposes that in a collateralized transaction, "haircuts" will be applied to the loan and the corresponding collateral separately. We recommend that the framework should recognize the benefit of transactions wherein the value of the loan and the collateral may move in the same direction, thereby reducing price risk inherent in the transaction.

State Street's risk measurement methodology and systems currently employed in our securities lending business incorporate diversification and co-varying effects of loans and collateral types. We view the proposed transaction-level measurement framework as a step backward compared to our risk measurement and management practices. In addition, compliance with the new accord will entail substantial costs for system and process changes.

The new accord will make existing securities lending activities significantly more capital intensive. The increased cost will make securities lending less attractive to the agent bank, the borrower, and/or the lender. This will cause a decrease in supply of lendable securities and result in reduced market liquidity.

Operational Risk

State Street strongly recommends the incorporation of operational risk in Pillar 2 for the many concerns that we have articulated earlier.

Notwithstanding our belief and recommendation, we support the continuation of the development of concepts, methodologies, formulations and data-gathering efforts to evaluate whether a risk-sensitive operational risk capital framework can be developed without causing undesirable systemic, competitive, and behavioral distortions in the global financial markets. Accordingly, we offer the following comments on specific elements of the operational risk section of the proposed new accord.

We support the fundamental notion that operational risk, for the purpose of any requlatory capital discussion, should exclude other risks, i.e., reputational, business and strategic risks, and the framework should only incorporate unexpected, but not catastrophic, losses, whereas expected losses should be covered by revenue as normal operating expenses. The definition of operational loss should also exclude opportunity cost and near misses, as well as investments made to improve controls or processes.

While we view the Spectrum Approach as a good theoretical framework to provide a continuum of quantification approaches with increasing sophistication and risk sensitivity, we believe that much additional work is needed to accomplish this objective.

The proposed measure of calibration must be re-evaluated and determined based on a comprehensive sample of institutions and the proposed (narrower) definition of operational risk. That is, the notion that 20% of an institution's capital should be allocated for operational risk appears to be inaccurate and results in an overly onerous capital requirement. As an approximation, we used the 30% of gross income measure as proposed in Option I and gauged it to State Street's operational loss experience. We concluded that the measurement grossly overestimated required operational risk capital.

Because Options I and II are deficient in risk sensitivity, Option III, the Internal Measurement Approach, is a very important and critical approach, as it represents the emergence of a more risk-sensitive approach that is based fundamentally on an institution's actual operational loss experience. We view actual loss data as a good basis for risk quantification as they reflect an institution's business activities, risk management practices, infrastructure, and controls. As a conceptual matter, enhancements and modifications can be made to the proposed formula to increase the ease of implementation and to improve risk-sensitivity. In this regard, it is particularly important that appropriate Business Indicators (EI) are selected, because we have determined, based on many years of data, that the proposed macro-level EIs such as assets under management, assets under custody and gross revenues have no statistically significant correlation with our operational losses.

While the new accord provides a place-saver for an Option IV, the Loss Distribution Approach, it is our view that this option should be further developed and used in any capital framework discussion as an option within the proposed Spectrum Approach. This methodology would be the most risk-sensitive alternative of all of the proposed options because it captures an institution's risk profile in the form of loss data and is best aligned with developing risk measurement and quantification practices. Furthermore, by using internal loss data as modeling input, the Loss Distribution Approach would be free of issues arising from the use of inappropriate exposure indicators and the assumption of linearity between losses and activity levels.

State Street is also concerned about the requirement in the new accord, that institutions must participate in data pooling efforts sponsored by private sector concerns as a de facto pre-requisite to enter into the more risk-sensitive options. We view our loss data as proprietary and confidential, the disclosure of which may cause competitive damage and legal and privacy concerns. If this data pooling effort is to move forward, we recommend that it be undertaken directly by the regulators with stringent security and confidentiality safeguards.

Risk Mitigation - Insurance

We recommend that the use of insurance be considered as part of any operational risk quantification framework as a risk mitigation tool or capital substitute.

Disclosure Enhancements and Requirements

We support the committee's goal to encourage market discipline through a set of disclosure recommendations and requirements. We also agree that disclosures concerning capital, risk exposures, and capital adequacy that are sufficient for market participants to assess a bank's ability to remain solvent should be required.

We are concerned, however, that the committee has widened its analysis too far in an attempt to complement the proposals set forth in Pillar 1 and Pillar 2.

There is also the issue of lack of comparability among institutions that may result from a materiality consideration for disclosure and the practical and cost considerations related to more frequent reporting.

Many of the proposed disclosures, including the approaches for which a bank qualifies (for both credit and operational capital assessment) and the detailed disclosures concerning risk management systems and risk loss experience, are complex and institution-specific and could be misunderstood by even a sophisticated reader. We also consider much of this information to be proprietary and in particular, have serious privacy and competitive concerns regarding the sharing of operational loss data with industry participants.

We submit that these concerns are shared by most participants in the U.S. banking industry and these concerns further support our proposal of managing operational risk through Pillar 2 treatment.

Generally, we conclude that the current levels of disclosures required by the Federal Reserve and the Securities and Exchange Commission (SEC) are sufficient to achieve the desired level of transparency and need not be further expanded.