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Basel Committee on Banking Supervision,
Bank for International Settlements,
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Dear Committee Members:

The Goldman Sachs Group, Inc. ("Goldman Sachs") is pleased to provide comments on the third Consultative Document on the New Basel Capital Accord ("the New Accord") that was issued by the Basel Committee on Banking Supervision ("the Committee") in April 2003. In doing so, we would like to express our appreciation of the efforts that have been made by the Committee to align capital requirements more closely with current risk management practices and to encourage ongoing improvements in risk assessment techniques.

This response is being sent in confidence to you and those identified below, and we request that it not be published or placed on the Internet.

I. Executive Summary

The impact of the New Accord will be felt by many institutions beyond those internationally active banks that fall directly under the scope of its application. Specifically, the Capital Adequacy Directive will impose broadly similar capital requirements on our operating subsidiaries within the European Union. Further, the Financial Groups Directive has the potential to impose capital adequacy standards at a consolidated level on multinational financial institutions operating within the European Union. We understand that the framework for applying such standards is likely to be influenced by the proposals contained within the New Accord.

While we are supportive of the New Accord's general goal of more closely aligning capital requirements with risk-management practices, we are concerned that the current proposal falls short of this objective in respect of certain trading book activities, as the risk weights result in capital requirements that are high in comparison with the loss-history of the risks they are designed to cover. As a result, these capital requirements will disproportionately affect those financial institutions whose trading book activities represent a significant proportion of their business. Unnecessarily high capital requirements for trading-book activities could result in negative consequences for liquidity in the market, and would likely lead to the allocation of capital resources in a manner inconsistent with our perception or experience of the underlying risks. Illustrating this point, our analysis of the impact of the New Accord on the consolidated results of Goldman Sachs, as well as the stand-alone impact on Goldman Sachs International, our major European subsidiary, indicates that capital requirements would increase substantially in comparison with the 1988 Basel Accord, even before the consideration of an Operational Risk charge.

II. Trading Book versus Banking Book Activities

Firms specializing in trading book activities may be placed at a substantial disadvantage in comparison with other financial institutions under the proposed New Accord. Accordingly, we draw your attention to a number of significant differences in the risk profile and management of trading book and banking book exposures:

- The trading book is predominantly composed of positions in securities, together with related funding transactions. In most cases, these securities are highly liquid, and the funding transactions are short-term in nature. By contrast, the banking book is predominantly composed of loans which, in comparison with securities positions, are less readily transferred to third parties, and tend to be held for a longer period (and often to maturity).

- All inventory positions in the trading book are marked-to-market on a daily basis. As a consequence of this long-standing discipline, the carrying value of assets is immediately reduced to reflect any losses the firm may have incurred, whether as the result of market fluctuations or the deteriorating credit quality of a counterparty. On the other hand, banking book exposures are generally not re-valued unless they have suffered a permanent impairment of value.

- Securities funding transactions contained in the trading book, such as repo / reverse repo and stock borrow / stock loan activities, are generally collateralized by highly liquid securities, are the subject of standard documentation that is recognized as being legally enforceable in most major jurisdictions, and are supported by dynamic risk management processes, including daily remargining and a process for rapid closeout in the event of trade defaults. This is in contrast to the characteristics of many of the assets contained in a banking book portfolio.

With these comments as background, the remainder of our response will discuss some concerns we have regarding specific aspects of the proposed New Accord.

III. Credit Risk: OTC Derivative Exposures

Under both the 1988 Basel Accord and the proposed New Accord, potential future exposure ("PFE") on OTC derivatives is computed by applying pre-determined percentages to the notional underlier of each individual contract. In our view, notional underliers are not an appropriate measure of risk and do not consider portfolio diversification benefits, either across or within counterparties. This approach for calculating PFE is inconsistent with the considerable progress that the Committee has made in aligning regulatory capital with economic risks with respect to retail and wholesale lending activities.

We note that the Committee has made an informal commitment to consider the development of a model-based method for computing PFE and we strongly support this initiative. However, we consider it vital that the work be completed in time to implement an appropriate capital requirement simultaneously with the New Accord. We therefore encourage the Committee to make a formal commitment in this regard.

We recognize the very significant amount of work required to develop an alternative treatment for OTC derivatives. Therefore, given the relative importance of this issue for institutions whose business is dominated by trading book activities, we recommend as an interim measure that the Committee allow national regulators sufficient flexibility to implement a more risk-sensitive capital requirement until such time as an appropriate methodology has been agreed.

IV. Credit Risk: Repo-Style Transactions

The capital requirements for repo-style transactions (i.e. repo / reverse repo, stock borrow / stock loan) are substantial, and considering that this business has a long history of virtually no credit-related losses, we regard them to be excessive.

We particularly draw your attention to the following matters:

- the 6-month implied holding period under the Foundation IRB approach is greatly in excess of the risk exposure period of most repo-style transactions, the vast majority of which are executed on an overnight basis;

- the maturity adjustment formula does not result in sufficiently low risk weights for very short-term transactions;

- the absence of an enforceable netting agreement should not invalidate the use of VaR-based exposure models under the Advanced IRB approach, as diversification benefits would still accrue to the portfolio.

We acknowledge the significant work done by ISDA and TBMA in providing further insight to the above matters and in proposing certain technical solutions.

V. Operational Risk

We welcome the introduction of a specific focus on Operational Risk within the overall framework of the New Accord, and we support the objective of encouraging significantly greater discipline in this area. Notwithstanding previous assertions by the Committee to the effect that the New Accord is not intended to cause a significant increase in average capital requirements as compared to the 1988 Basel Accord, we note that this is not our experience. In fact, as previously noted, our analysis indicates that our overall capital requirements increase under the New Accord, even before consideration of Operational Risk. Accordingly, the impact of an Operational Risk charge assumes even greater significance than would otherwise be the case.

Much work is yet to be done in order to develop sound methods for determining capital requirements for Operational Risk. Given the scarcity of relevant data and lack of proven methodologies, we believe the development of a risk-measurement system to be a multi-year initiative, if its results are accurately to reflect the control environment and size of each business. We continue to believe that the discipline of Operational Risk management is not yet sufficiently developed to justify the implementation of a Pillar 1 capital requirement, but rather that appropriate risk management practices should be encouraged through the Pillar 2 framework. While it may ultimately be appropriate for a Pillar 1 capital requirement to be based on these methodologies and supporting databases, this approach should not be implemented until they have proved, over time, to be sufficiently robust to form the basis of such a quantitative determination.

However, understanding that the Committee may conclude that a Pillar 1 requirement is appropriate for Operational Risk, we believe that these capital requirements should be based primarily on the internal loss experience of individual institutions, together with a consideration for Pillar 2 supervisory oversight of their Operational Risk mitigation policies. Further, we support the Committee's efforts in developing the principles outlined in the Sound Practices Paper and would welcome continued development along these lines.

The following are additional specific comments on Operational Risk proposals within the New Accord, should the Committee require a Pillar 1 capital requirement:

- In order to apply the Advanced Measurement Approach to Operational Risk, firms must meet certain qualitative and quantitative standards. We are concerned that certain quantitative standards are overly prescriptive, given the limited history of data collection across the industry and the potential risk weighting attributed to certain low-frequency / high-impact loss events. Specifically, the soundness standard implied by a 99.9% confidence interval may not be appropriate. We recommend that the reference to a 99.9% confidence interval be replaced with a standard that allows individual firms to set a confidence level consistent with that used for the internal management of Operational Risk.

- Under both the Basic Indicator and Standardized Approaches for Operational Risk, the capital requirements for Corporate Finance and Sales and Trading activities have been set at percentages of average annual gross income which generate capital requirements a significant multiple greater than the loss-history we have experienced.

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We have contributed our views to a number of industry groups who are examining the proposals contained in the New Accord. In particular, we share a number of technical concerns with the Securities Industry Association ("SIA"), the London Investment Banking Association ("LIBA"), The Bond Market Association ("TBMA") and the International Swaps and Derivatives Association ("ISDA").

In closing, we wish to repeat our support of the efforts of the Committee, and to express our desire to assist the Committee in any way that would be helpful.

Sincerely yours,

John A. Thain

cc:
Sir Howard Davies, Chairman, Financial Services Authority

The Honorable William H. Donaldson, Chairman, United States Securities and Exchange Commission

The Honorable John D. Hawke, Jr., Comptroller of the Currency

The Honorable Alan Greenspan, Chairman, Federal Reserve System