Third Consultative Document on The New Basel Capital Accord

Response to the Basel Committee on Banking Supervision.

Merrill Lynch & Co.

July 2003

30 July 2003

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

Dear Sirs

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

Merrill Lynch & Co., Inc. ('ML' or 'we') very much welcomes this opportunity to respond to the Basel Committee on Banking Supervision ('the Basel Committee') on its proposals set out in the third consultative paper on the New Basel Capital Accord ('the Accord' or 'CP3') published on 29 April 2003.

We have fully participated in the Committee's prior consultations and other related work since deliberations began back in 1999. We recognise and strongly welcome the efforts of the Committee to seek to address the many and varied concerns held by industry. This is reflected in the current proposals which represent a considerable evolution from earlier versions. However, we do have some significant "Matters of Note" which we set out in the accompanying pages to this letter. In particular we have the following significant concerns with the proposals:

Treatment of Counterparty Risk in the Trading Book

- We believe that this is an area that still requires considerable thought and discussion in order to deliver risk sensitive and proportionate proposals. To this effect we fully endorse the Counterparty Risk comments in the International Swaps and Derivatives Association ('ISDA')/ The Bond Markets Association ('TBMA') joint response (summarised in the main body of our response).

- We welcome the promise by the Basel Committee to work with industry to update the treatment of OTC Derivatives. This review must also include Securities Financing Transactions and should commence without delay.

Operational Risk

- We continue to believe that Operational Risk is more suited to treatment under Pillar 2, especially for low-frequency high-impact events where measurement and evaluation is subjective.

- We continue to have strong reservations about the proposals for the Standardised Approach. These appear to be based on the view that from an Operational Risk perspective the Trading Book is riskier than the Banking Book. We find this presumption troubling and can find no justification for it in the proposals.

We have fully participated in, and accordingly generally endorse the responses of trade associations of which we are a member. In addition to ISDA and TBMA mentioned above, these are the London Investment Banking Association, the British Bankers Association and the Securities Industry Association.

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 Steve Teather (+44-20-7867-4848 or steve_teather@ml.com).

Yours sincerely,

John Fosina
Corporate Controller
Merrill Lynch & Co., Inc.

David Brooks Gendron
First Vice President, Chief Financial Officer
Merrill Lynch Europe, Middle East and Africa

Matters of Note

We appreciate that the Committee wishes to complete the Accord by the end of 2003. We therefore restrict our comments to those matters of particular concern and importance to ML. We believe that many industry members share these concerns. ML is not a so-called "Basel Bank" and not a direct constituent of the group for which the Accord is prepared. However, the ML Group does contain subsidiaries that will be subject to the Accord and so are impacted by the Committee's proposals. We hope our comments will be considered.

Credit Risk

The Committee has naturally concentrated on the Banking Book during the development of the Accord. Consequently, Trading Book matters have received less attention; though we welcome the increased attention which has been paid recently. However, a number of matters remain to be addressed.

ISDA / TBMA Response – Counterparty Risk Comments

We do not wish to repeat here the well-articulated comments in the ISDA / TBMA response which we fully endorse. ISDA / TBMA raise matters that are particularly important to ensure that the Accord does not have unintended consequences or disproportionate impact on the Trading Book. The ISDA / TBMA comments are summarised below for convenience:

- Capital Treatment of Credit Derivatives
    - Treatment of restructuring risk in credit default swaps: welcomes the recognition of restructuring where it is in the control of the guarantor and seeks to provide some recognition where such control is not demonstrated to exist.
    - Credit default swap add-ons: queries the application of the add-on to sellers of credit risk and notes that the add-on for qualifying items is too large.
    - Substitution / double default risk: concern that there is no recognition for the smaller probability of both counterparty and guarantor defaulting under the substitution methodology.
    - Specific risk off-sets: arbitrary percentage off-set prescribed is not risk sensitive and suggests that credit risk positions should be represented as Floating Rate Notes to allow appropriate off-set.
    - Operational requirements applied to CDSs: seeks to ensure that the proposals will allow the use of Master Netting Agreements.
- Counterparty Risk
    - Use of VaR for repo-style transactions: concerns expressed over a potentially onerous and penal back-testing regime.
    - Treatment of potential exposure: current add-on methodology is too crude and does not meet the same risk sensitivity standards of the rest of the proposed Accord. A review and update has been promised but this must be timely.
- Maturity
    - Maturity adjustment below one year: seeks to ensure that IRB methodology is appropriate for shorter maturities.
    - Effective maturity adjustment for repo and derivatives: suggests a standard maturity of one year for OTC derivative trades and six months for repo transactions.
    - Treatment of maturity mismatches: queries why a standardised linear scaling factor approach is used.

It is essential these matters which relate largely to Trading Book exposures are satisfactorily addressed.

QIS 3

The Committee's QIS3 results showed that the Trading Book charge is expected to increase significantly, even under the most advanced methodology[1]. This accords with our own observations. We are concerned that the Committee dismissed the Trading Book impact as immaterial. However, this is simply a function of the relative size of the Trading Book in the QIS3 sample. This sample did not include firms with predominant Trading Books, such as ML. The importance of the Trading Book business means that the impact cannot be ignored.

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[1] Per "QIS 3 – Overview of Global Results" published by the Basel Committee in May 2003: % change in capital requirement for the Trading Book under (1) Standardised Approach = +12%, (2) Foundation IRB = +4%, and (3) Advanced IRB = +2%.

Treatment of Settling Transactions

The Committee's proposed treatment of settling transactions has only recently become clear. Paragraph 292 which ostensibly relates to maturity adjustment, has been interpreted as meaning that the 4-day settlement grace period will no longer apply. If correct we find this very troubling.

The grace period recognises the administrative nature of resolving settlement errors (i.e. settlement risk). Genuinely failed trades uncleared within 4 days appropriately attract a Credit Risk charge. Settlement Risk is covered under the Accord's proposals for Operational Risk and removal of the grace period would represent a double capital hit.

We recognise that conceptually credit risk is present in trades such as securities sales and purchases settling in less than 4 days. However, the cost of maintaining systems and processes to enable counterparty risk management of this high volume settlement activity would be significant. Such costs would far outweigh any risk management benefits, particularly given there is little or no historical data evidencing credit losses associated with this activity.

We question whether the Committee has assessed the likely market impact of this proposal. The volume and value of unsettled trades in the market would require a very significant additional amount of capital to be set aside. We do not believe that this extra capital is justified for the minimal credit risk present. The Committee must also be mindful that these proposals will be applied to smaller institutions, and we would caution that the impact on the retail broking industry must be assessed. It is likely that most firms would have to make significant changes to their regulatory systems to capture these unsettled trades.

For clarity we ask the Committee set out its intentions in this area and particularly to define the scope of "settling transactions".

We note that this matter is also specifically addressed in the ISDA / TBMA response which we support.

Application of IRB in an Innovative Environment

The Committee is right to bear in mind the impact on innovation of its proposals. We are concerned as to how new products will be catered for in the IRB methodology. Innovation is fundamental to our business and it is essential that new products can be accommodated within IRB, as otherwise they might not be economically viable. New products by definition do not have a credit and default history and so may be excluded from the IRB by reason of this.

We would appreciate specific clarification within the Accord that new products are not by their nature excluded from the IRB.

Securitisation

The prescribed risk weightings for securitisation exposure are calibrated to reflect the risks of corporate bond and loan portfolios. Such an approach results in excessive risk weights compared to the economic risks of securitisation tranches, particularly for retail and mortgage portfolios.

We believe that sophisticated banks should be allowed to use models to determine risk capital allocation for securitisation exposures and expand the use of the Supervisory Formula Approach ('SFA'). Furthermore, we believe the SFA should be modified to allow application of different betas depending on the securitisation exposures in question.

It is necessary to calibrate the Rating Based Approach better to reflect the diversity in securitisation. We believe that a set of different risk weights corresponding to different securitised exposures (e.g. consumer loans, mortgage loans, commercial real estate), as well as corporate exposures, should be developed.

Operational risk

Recent work has tended to concentrate on the Advanced Measurement Approach ('AMA'). We believe that certain operational risk events, particularly low-frequency high-impact ones, are unsuited to measurement and evaluation. To this effect we continue to believe that they should be assessed under Pillar 2. We have significant concerns with aspects of the less risk-sensitive approaches, particularly the Standardised Approach, and these are set out below.

Calibration of Betas

The set betas give rise to perverse incentives. The Trading Book business lines (Trading and Sales, and Corporate Finance) attract a beta of 18%. There is no incentive for firms with significant Trading Book business to seek to progress from the Basic Indicator Approach to the Standardised Approach. We find it odd that the Committee should crystallise such an incentive. The relatively high standards for the Standardised Approach means it is essential that no beta is higher than the alpha.

We do not view Trading Book business as more risky from an operational risk perspective. Indeed we would view Banking Book activities as generally more risky, if only because we are less active in these areas. The Committee's own research[2] does not suggest that the Trading Book business lines are inherently more risky.

We note the Committee has recognised the problem of double counting for certain high-margin banking book business lines. We note that in general trading book business is also high-margin though largely due to market risk rather than credit risk. The double counting that the Committee recognises as a problem is compounded by artificially high betas. Failure to lower these betas would result in a triple impact: high revenue resulting in high operational risk charge, high market risk charges and a penal beta.

Taking all these matters together we find there is compelling reason for the Committee to lower the 18% betas to less that 15%. Our overriding concern is that the apparent riskier nature of the Trading Book will become institutionalised and that Trading Book Operational Risk charge will always be benchmarked against 18% even if AMA is adopted. This is not justified, and is contrary to the level-playing field concept.

As an alternative we suggest that the beta's could be further differentiated by way of "core" versus "non-core" business. Core business would attract a lower beta to recognise the fact that firms would have substantial controls, experience and well-established governance practices in place as required by the qualitative standards.

Operational Risk Boundary with Market Risk

There is overlap between Market Risk and Operational Risk similar to that identified between Credit Risk and Operational Risk. Where a pricing loss derives from an operational failure it is unclear whether it should be treated as either Market Risk or Operational Risk. Clarity is needed to avoid double counting and overstating capital. It would not be practical to isolate market risk losses deriving from operational failure within the market-to-market process. The mark-to-market approach means that losses are treated as a 100% capital charge anyway.

We would appreciate clarification of the treatment of the boundary between Market Risk and Operational Risk.

Reporting Interval

We suggest that the computations for determining Operational Risk capital be updated less frequently than those for Market or Credit Risk. Since a firm's Operational Risk profile is largely dependent on its senior management, governance processes, and controls, we would anticipate that such factors would change much more slowly than market fluctuations, market positions, and credit exposures that drive the Market and Credit Risk capital computations. We suggest that the calculation be done annually. Regulators should retain the option of intra-year updates whenever it appears that a firm may have significantly altered its risk profile (e.g., through a strategic restructuring or acquisition).

99.9% Confidence Interval Requirement

We believe that it is premature to require a specific 99.9% confidence interval. This may turn out to be an unfair or unattainable standard. At this stage in the evolution of operational risk methodologies regulators should require firms to justify the confidence intervals used in their models.

<u>Pillar 2</u>

Stress Testing

We accept the importance and value of stress testing in determining economic capital. It is an essential component of risk management and therefore a valid requirement in the Accord.

However, if the Committee is unwilling to recognise a firm's Credit Risk model for regulatory capital purposes then it is inappropriate to require stress testing in Pillar 1. As such paragraphs 396 to 399 are not appropriate to Pillar 1 and should be moved to Pillar 2 to complement paragraph 684.

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[2] *2002 Loss Data Collection Exercise for Operational Risk published by the Basel Committee on 14 March 2003.*

General

Transitional Arrangements

We note the Committee's aim to maintain the level of capital across the banking industry. This means that on average the expected decrease in Credit Risk capital is matched by the new Operational Risk charge. The Committee seeks to monitor this by requiring firms to continue to perform the Basel 1 computation in parallel. Additionally the Committee seeks to limit any beneficial impact by maintaining a floor for two years after implementation.

We understand the need for these arrangements, though we should point out that this approach is unbalanced. There are many firms that will see their regulatory capital significantly increase. If the imbalance remains the Committee will find it difficult to keep to its aim of maintaining the level of capital in the banking system. Limiting the benefits without similarly limiting the costs will lead to distortions and increase the level of capital. It is therefore essential that as part of a prudent approach to implementation some form of capital cap or ceiling be imposed so as to allow a smooth transition. Failure to do so will introduce unwarranted competitive distortions.

Scope

We do not believe that consolidation at every node in a group ('sub-consolidation') is appropriate. This will be an expensive imposition for groups, particularly large groups. We believe the marginal benefit to supervisors will not outweigh the cost to firms.

Use of Data

Data scarcity is an issue, and is more acute in some areas, e.g. the Trading Book. As a result we are keen that the Committee allows group data to be used at the individual legal entity level. Such data will of necessity span geographical and regulatory boundaries, but given it would derive from a similar system and control environment we would consider it more relevant than third party external data.

Data collection and use are key element of the Credit and Operational Risk methodologies. It is essential that the Committee states clearly its requirements in respect of data collection and use. Given the ambiguity of the term "bank" in the Accord[3] it is unclear whether data should be collected and used at the legal entity or consolidated basis.

We would appreciate clarification that firms could use wider group data at the legal entity level.

Home / Host Issue

As a global organisation with entities in multiple jurisdictions we are subject to the regulatory requirements of many different supervisors. We therefore wish to add our support to the many industry comments that seek a sensible and pragmatic solution to the issue of lead supervision and regulatory approval across multiple jurisdictions. This is particularly acute for ML, in comparison to many other financial groups, in that we do not have single dominating bank to which the CP3 proposals will apply.

[3] *For example, in paragraph 640 there are references to the singular "bank" that appears to be contradicted by the reference in the forth bullet that "the bank…roll out the AMA across all material legal entities and business lines". It is not clear therefore whether partial AMA use is at the legal entity or consolidated level.*