August 1, 2003

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

Dear Committee Members:

State Street appreciates the opportunity to comment on the proposed New Basel Capital Accord, as described by the Committee's Third Consultative Paper (CP3). As a leading specialist in meeting the needs of sophisticated global investors, State Street has significant historical experience and expertise in managing risk, and is pleased to offer its insights into the development of a flexible, risk-sensitive capital adequacy framework.

State Street applauds the significant investment of time and effort placed by the Committee in the development of CP3, and supports the Committee's goal of updating and improving the original Basel Capital Accord. Nevertheless, after careful review of CP3, our fundamental position remains unchanged from that outlined in previous submissions to the Committee. In particular, we remain strongly opposed to the proposed new regulatory capital requirement for operational risk, and urge the Committee once again to abandon this misguided proposal in favor of a strong, effective, Pillar 2 treatment of operational risk.

While CP3 focuses extensively on the calibration of methodological and technical requirements of the proposed New Accord, the broader policy implications of the proposed framework remain unaddressed. State Street continues to be concerned with the negative competitive impact among banks and non-banks, the likely unevenness of application across national jurisdictions, and the potential unintended consequences upon the global financial system of the proposed Accord. The Committee should not agree to a regulatory framework as potent, far-reaching, and complex as the proposed Accord without the benefit of careful and thorough evaluation of its potential impact on the structure of the financial services industry, the relative competitive positions of firms, and the consequences of "getting it wrong." Focusing on the technical aspects of the proposed Accord may create the appearance of sophistication, or even mathematical certainty, but in fact, may simply render the policy results "more precisely" wrong. A highly dynamic system, such as today’s competitive marketplace, is ill suited to policy experimentation, since errors can have unintended, irreparable, negative consequences for market participants.

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In addition to the still uncorrected competitive and methodological flaws outlined in our previous comment letters, recent announcements by U.S. regulators regarding the scope and methodology of planned application of the New Accord in the U.S. have further compromised its potential effectiveness. U.S. regulators' plans to apply the New Accord to only a very limited number of banks, and to limit both mandatory and voluntary compliance with the New Accord to the most complex --- and costly --- approaches, have fundamentally altered the dynamics of the proposed new capital regime. In the U.S., at least, the New Accord has been shifted from an "incentives" based approach to a "sanctions" based approach. In doing so, U.S. regulators have removed key elements of flexibility promised by the New Accord, and eliminated the ability of U.S. banks to choose risk management and capital calculation methodologies most suited to their position in the marketplace.

The Committee's more advanced approaches to credit risk are very prescriptive and highly complex. This is particularly evident in the treatment of securitization exposures. Securitizations play a key role in today's financial markets. The proposed rules are extremely complicated, will be burdensome to implement, and are very difficult to interpret with any level of confidence. The rules do not properly distinguish risk profiles associated with the different roles a financial institution may play in the asset securitization market.

In addition, we urge the Committee to clarify the interaction between host and home regulation under the proposed Accord, an issue which raises serious concerns for any internationally active bank. Under CP3, it remains extremely unclear how regulators will ensure consistency of application of the Accord across jurisdictions, thereby creating the possibility of multiple, parallel calculation and compliance efforts within individual banks. Requiring separate capital calculations at the individual subsidiary level raises numerous policy and practical concerns. The result will be a costly compliance exercise, with little or no benefit for the safety and soundness of either individual banks or the financial system as a whole.

Finally, we urge the Committee to reconsider its proposal to require extensive new Pillar 3 disclosures. U.S. banks are already subject to extensive public disclosures, which provide a transparent basis for comparisons between financial institutions, both banks and non-banks. The new, highly detailed disclosures proposed only for banks under CP3 will do little to improve transparency or market discipline.

Our comments today, then, are composed from the perspective of a specialized U.S. banking institution which expects to be compelled, by either regulatory or market pressures, to comply with the restrictive U.S. implementation of the New Basel Accord.

**New Regulatory Capital Requirement for Operational Risk Remains Deeply Flawed**

Despite the introduction of the Advanced Measurement Approach (AMA), we remain strongly opposed to a new Pillar 1 capital requirement for operational risk, and deeply concerned by the potential competitive impact of the proposal in the marketplace.

U.S. banks operate in a highly competitive environment, competing directly with investment management firms, brokers/dealers, insurance companies, investment banks, mutual funds, benefit consultants, leasing companies, and business services and software companies that are not covered by the proposed capital requirements. In all of these cases, non-Basel 2 competitors, both banks and non-banks, will exploit their competitive capital advantage, undermining the profit potential and competitiveness of Basel 2 banks.
In addition, we have little confidence that the operational risk component of the New Accord will be applied evenly across national jurisdictions. As has often been noted by the U.S. Comptroller of the Currency, U.S. banks operate in a far different, and often stricter, regulatory environment than many of our overseas competitors. The result is a high potential for competitive disadvantage for U.S. banks.

State Street, as a leading global investment servicing and investment management provider, is highly attentive to the issue of operational risk. In fact, managing such risk effectively is a key element of confidence in our relationship with our clients. Our long historical record of extremely low operational losses validates our ability to manage such risks. We very aggressively seek to improve our management of operational risk. However, we continue to believe that operational risk is first and foremost an "earnings-at-risk" versus a "capital-at-risk" issue. In our experience, operational losses have been covered many times over by earnings.

For a specialized bank such as State Street, the competitive issues raised by the proposed new operational risk capital requirement are particularly acute. First, such specialized banks will realize little or no offsetting benefit from the changes to the credit risk regime. Second, these banks disproportionately compete with institutions that will not be subject to the New Accord --- both non-banks, and, in the U.S., non-Basel 2 banks.

The proposed new regulatory capital requirement for operational risk is a misguided attempt to force operational risk management into a model more suited for credit risk. The proposal, by focusing primarily on regulatory capital, shifts attention and resources away from critical risk management efforts, and creates perverse incentives away from investment in important operational risk infrastructure, processes, and people.

The marketplace distortions created by the new operational risk requirement will create an incentive to move businesses outside of the Accord's reach. The result of such regulatory arbitrage will be an increase in activity outside of established bank regulation, potentially increasing systemic risk to the financial system.

Despite the Committee's attempt to make its operational risk proposal more risk-sensitive through the AMA, we also remain deeply concerned by the technical aspects of the proposal. The AMA incorporates numerous and extensive quantitative and qualitative requirements, which are exceedingly complex and untested. It is far from clear that the resulting highly complex regulatory framework improves the operational risk proposal --- it may, in fact, simply render it unworkable.

In addition, supporters of a Pillar 1 approach to operational risk consistently argue that "comparability" between institutions is a critical regulatory goal --- a goal all but abandoned by the highly complex, subjective AMA proposal. The AMA also suffers from misguided reliance on external data. External data provides valuable information for qualitative reviews of an institution's risk management systems and internal controls. It is not, however, suitable as a basis for a quantitative capital calculation. Scaling external data to make it relevant to a bank's risk profile, system of internal controls, and other risk management factors is a difficult and uncertain process. Moreover, the integrity, completeness and general data quality of external databases are often questionable and difficult to ascertain and control. In addition, much publicly available operational loss data is based on relatively extreme risk management failures; mandating use of such data risks imposing capital requirements based upon the "lowest common denominator" of risk management practices. Sharing such data between institutions, or other third parties, will also raise serious privacy, confidentiality, legal, and competitive
issues. We are also concerned, as we have previously commented, with proposed methodologies to supplement quantitative capital assessment with "scenario analysis" and "scorecards," which are themselves fraught with conceptual and methodological problems.

Finally, we are concerned by the Committee's apparent desire to use a new operational risk capital requirement as a "plug" to mitigate potentially dramatic reductions in regulatory capital for some banks due to changes in the credit risk regime. The Committee's current effort is premised on the widely acknowledged need to increase the risk sensitivity of the 1988 Accord's credit risk framework. Adoption of a new operational risk capital requirement to offset potential reductions in required capital from credit risk changes is inconsistent with this goal.

U.S. Application of New Accord solely to "Core Banks"

With much of CP3 remaining unchanged from previous Committee releases, our overall comments regarding the proposed New Accord remain very similar to those filed in the past. One very significant change, however, has occurred outside of the confines of the Basel Committee, when U.S. regulators announced that they will only apply the New Accord to 10-12 "core" banks in the U.S., and that these banks, and any "opt-in" banks voluntarily submitting to the New Accord, will be required to use only the AMA and the Advanced IRB approaches.

The U.S. decision to limit application of the New Accord to very few banks further compromises the Committee's already flawed approach to operational risk. By leaving many U.S. banks outside of the reach of the New Accord, and thus not subject to an operational risk capital requirement, U.S. regulators will aggravate the competitive distortions created by the proposal. Under the U.S. proposed implementation of the New Accord, banks competing in identical business lines will face markedly different capital requirements.

The proposed U.S. approach to implementation of the New Accord is equally misguided in relation to credit risk. The decision by U.S. regulators to require use only of the Advanced IRB approach creates a "one-size-fits-all" approach which fails to recognize fundamental differences in the business line profiles of U.S. banks. Specialized banks with relatively low levels of credit risk will face dramatically increased compliance costs under the Advanced IRB, for little or no benefit. These same specialized institutions will bear a disproportionate burden from the new operational risk requirement, compounding the negative competitive impact.

Treatment of Asset Securitizations

The proposed rules for securitizations are extremely complex and difficult to interpret. As a result, it is impossible to evaluate fully the impact of the proposal, both on individual banks' capital requirements and the financial markets in general.

Specific issues with the various approaches to securitizations offered by the New Accord have been well documented by comments from numerous trade groups representing industries active in the securitization area. We do not believe that the proposed rules --- under the Standardized Approach, the Ratings Based Approach (RBA), or the Supervisory Formula Approach (SFA) --- provide a viable method for measuring required capital for liquidity facilities.

Under the Standardized Approach, the New Accord proposes a highly punitive one-for-one deduction from capital for unrated assets held by conduits, creating the incorrect impression that unrated assets are necessarily below investment grade, or inherently risky. A docket of the Standardized Approach will dramatically change the economics of securitizations, either through
unduly increased capital requirements, or excessive costs incurred to rate assets solely for the purposes of regulatory capital requirements. If the underlying transaction is unrated, the corresponding liquidity facility should not be treated as a capital deduction as long as the bank can demonstrate the underlying transaction to be at least investment grade equivalent.

Under the advanced approach, the RBA is inappropriate since it requires external ratings for liquidity facilities. It is not current industry practice to obtain such ratings for liquidity facilities; obtaining such ratings would be extremely costly and of dubious value outside of meeting the RBA requirements.

The Committee’s alternative to the RBA, the SFA, is itself highly complex, extremely burdensome, and costly to administer. For example, the SFA involves a calculation of $K_{IRB}$ which requires estimates of PD and LGD. However, liquidity providers that do not originate assets, such as State Street, do not have access to proprietary PD data, and will need to establish proxy methodologies for estimated PD. In numerous sections of CP3, the Committee indicates that when data is limited, banks should use a conservative bias in making estimates. For asset securitizations, the result will be an artificially high $K_{IRB}$. As a key component of the Supervisory Formula, an inappropriately high $K_{IRB}$ will result in a conservative and excessive capital requirement. In addition, the proposed requirement for a distinct calculation of risk-based capital for each individual transaction each quarter is extremely burdensome.

We support the Committee’s efforts to address risk created by asset securitization activity, but are concerned that the additional costs and burden resulting from the application of these rules will negatively impact the attractiveness of this type of financing, resulting in higher cost of financing in the capital markets and negative consequences for the U.S. economy as a whole. We urge the Committee to recognize the full range of asset securitization activity by banks, and to proceed cautiously in order to avoid disrupting an important source of liquidity for the financial markets.

Home/Host Issues

We urge the Committee to provide greater clarity on the application of the New Accord across national borders. The New Accord provides for the exercise of national discretion in its implementation by domestic regulators, assuring a wide variation of rules between national jurisdictions. Under CP3, the interaction between host and home regulation is far from clear. We remain very concerned by the potential for an inconsistent regulatory regime for internationally active banks, and by the risk of very high compliance costs which may result from the need for parallel, but different, capital calculations in multiple regulatory jurisdictions. On a more technical note, we are concerned that the data requirements of the more advanced measurement approaches may be difficult to meet on a jurisdiction-by-jurisdiction basis.

Pillar 3 Disclosures

State Street remains concerned by the effectiveness and the competitive impacts of the Pillar 3 disclosures proposed by CP3. While we agree with the Committee’s goal of creating a “consistent and understandable framework that enhances comparability,” we fear that the proposed Pillar 3 disclosures will have the opposite effect.

In general, the use of the Advanced IRB and the AMA, as planned for all Basel 2 banks by U.S. regulators, creates significant barriers to comparability between institutions. The use of internal modeling and other highly subjective methodologies will result in significant inconsistency of
application under the New Accord. CP3 allows supervisors to permit exposures in non-significant business units and immaterial asset classes to be exempted from the Advanced IRB, creating additional challenges to comparability. The definition of materiality itself is left to individual banks, further compromising uniformity between institutions. All of these factors contribute to a regulatory regime under which the extensive and highly technical disclosures required by Pillar 3 will provide little meaningful improvements in transparency or market discipline.

The proposed Pillar 3 disclosures will have negative competitive impacts for U.S. banks subject to Basel 2. Basel 2 banks will be required to make numerous new disclosures regarding the scope of application of the Advanced IRB, capital structure, capital adequacy, credit risk, equities in the banking book, credit risk mitigation, asset securitization, market risk, operational risk, and interest rate risk in the banking book while non-Basel 2 banks and non-bank competitors will not. As with other elements of the proposed New Accord, we are also concerned that inconsistent application of the Pillar 3 requirements in other regulatory jurisdictions will create further competitive disadvantage for U.S. banks.

Finally, we continue to have concerns that the Pillar 3 disclosures may conflict with existing accounting principles generally accepted in the United States, which may result in disclosures outside of a bank’s annual and quarterly financial statements. Such a new layer of financial reporting would be burdensome for Basel 2 banks, and would create the need for users of financial data to access several sources to assemble a complete discussion of a bank’s risk environment. The result would be significantly increased accounting, auditing, and legal costs to Basel 2 banks, without corresponding increases in transparency or market discipline.

Conclusion

Once again, thank you for providing State Street the opportunity to comment on the proposed New Basel Capital Accord. Despite our concerns, we remain supportive of the Committee’s overall effort to reduce risk in the global financial system, and appreciative of the Committee’s willingness to consider our comments.

Sincerely,

David A. Spina
Chairman and Chief Executive Officer

cc: Alan Greenspan, Chairman, Board of Governors of the Federal Reserve System
Roger Ferguson, Jr., Vice-Chairman, Board of Governors of the Federal Reserve System
John D. Hawke, Jr., Comptroller of the Currency
Donald Powell, Chairman, Federal Deposit Insurance Corporation
Jamie B. Stewart, Jr., First Vice President, Federal Reserve Bank of New York
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