Advanced Notice of Proposed Rulemaking on Implementation of the New Basel Capital Accord

Response to Federal Deposit Insurance Corporation, the Board of Governors of the Federal Reserve System, the Office of Thrift Supervision and the Office of the Comptroller of the Currency

Merrill Lynch & Co.

November 3, 2003

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November 3, 2003

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Attention: Comments
Federal Deposit Insurance Corporation
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Washington, D.C. 20429

Ms. Jennifer J. Johnson, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, D.C., 20551
ATTN: Docket No. R-1154

Regulation Comments
Chief Counsel's Office
Office of Thrift Supervision
1700 G Street, N.W.
Washington, D.C. 20552
ATTN: 2003-27

Office of the Comptroller of the Currency
250 E Street, S.W.
Public Information Room, Mailstop 1-5
Washington, D.C. 20219
ATTN: Docket No. 03-14

Dear Sir / Madam:

Advanced Notice of Proposed Rulemaking on Implementation of the New Basel Capital Accord

Merrill Lynch & Co., Inc. and its subsidiaries, including Merrill Lynch Bank USA and Merrill Lynch Bank & Trust Co. ('ML' or 'we') very much welcome this opportunity to respond to the Federal Deposit Insurance Corporation (the 'FDIC'), the Board of Governors of the Federal Reserve System (the 'Fed'), the Office of Thrift Supervision (the 'OTS') and the Office of the Comptroller of the Currency (the 'OCC') (collectively the 'Agencies') on the interagency proposals set out in the Advanced Notice of Proposed Rulemaking ('ANPR') published on August 4, 2003.

The proposals in the ANPR will have both direct and indirect application to ML's operations. The FDIC regulates the major element of ML's Banking business. The Securities and Exchange Commission (the 'SEC') has recently announced its intention to adopt the Basel Committee's proposals as the basis for its consolidated capital adequacy supervision of Investment Bank Holding Companies and Consolidated Supervised Entities. Major ML subsidiaries worldwide, particularly in Europe, will have to follow regulations that will have their basis in the Basel Committee's proposals.

We would like to state initially that we have found the ANPR document to be extremely useful. It has greatly improved our understanding of the Basel Committee's proposals. In particular, the ANPR has provided helpful guidance on a variety of key aspects, such as the supervisory expectations during planned implementation in the U.S.

We have fully participated in all the prior consultations by the Basel Committee for Banking Supervision whose proposals underlie the ANPR proposals. We have been, and remain, in active dialogue with the European Commission on their implementation of the Basel Committee's proposals in the form of the Risk Based Capital Directive ('RBCD').

In addition, we participated in the collaborative development of the joint response to the ANPR by the International Swaps and Derivatives Association ('ISDA') and The Bond Market Association ('TBMA'), and also the response by the Securities Industry Association ('SIA'). We fully endorse the comments in those responses.

Further, we responded to the Basel Committee's CP3 in July 2003. Many of the comments in our CP3 response are relevant to this response. To avoid repetition we append our CP3 response to this letter (see Appendix 2). However, we do seek to highlight some significant "Matters of Note" (see Appendix 1) specifically in respect of the ANPR, which we set out below:

1 Counterparty Risk in the Trading Book

1.1 Need for a Wider Review of Treatment of Counterparty Risk

The treatment of Counterparty Risk in the Trading Book has not received the same level of attention and discussion as Credit Risk in the Banking Book. The present treatment of OTC derivatives is unchanged. The proposed treatment (as we understand it) for settling / unsettled transactions has been hastily constructed. The new treatment of repo-style transactions ignores loss history and diverges from economically similar transactions (e.g., OTC derivatives). The treatment of credit derivatives fails to recognize market developments and the risk mitigating effects of credit derivatives and imposes inappropriate capital requirements on the market making activities necessary to underpin this important market.

We view the separate development of different treatments for repo-style transactions and OTC derivatives as a weakness in the proposed capital framework. Repo-style transactions are fundamentally forward contracts. Therefore, they should have the same treatment as OTC derivatives for loan equivalent purposes. In particular, we strongly support the ISDA discussion and proposal that the loan equivalent for both OTC derivatives and repo-style transactions should be determined by the expected level of Potential Exposure, with the alpha factor as a multiplier, rather than by the 99-percentile. The Counterparty Risk of credit derivatives would be most appropriately covered by this approach rather than through a segregated treatment.

We are encouraged by the Basel Committee's apparent willingness to review the wider treatment of Counterparty Risk. This review must include the possibility of introducing a modeling approach for OTC derivatives and repo-style transactions as noted above. We hope that the Agencies support the need for this review. However, the timetable for this review is uncertain and any delay in fully reviewing the Counterparty Risk treatment will create additional problems. It is not readily apparent from the ANPR how the Agencies would seek to incorporate this future Basel work.

1.2 Treatment of OTC Derivatives

We note above that the treatment of OTC derivatives has not been updated, and that this may be rectified by the development of a modeling approach. Our analysis suggests that the proposed treatment of OTC derivatives results in capital requirements that significantly exceed the actual credit risk created by these trades. We reiterate the need for substantial revision in this area, as presently there is a distinct lack of risk sensitivity for OTC derivatives. In particular, retaining the EAD representation of OTC derivatives from Basel I approach would result in a very significant distortion of their relative contribution to the overall risk capital. In addition, we strongly believe that appropriate revisions to OTC derivatives EAD treatment should include repo-style transactions and counterparty risk of credit derivatives.

1.3 Systems and Procedures

Our concern as to the lack of focus on Counterparty Risk (as noted above) is best highlighted by looking at the proposed impact on systems and procedures in the wholesale market by using our current understanding of the proposed treatment of settling DVP trades as an example. We understand that capital would be required against the credit exposure arising from the date of execution of a trade to the date of settlement. The procedures undertaken by broker-dealers have developed over the years and are finely tuned to the nature of the market. Any (theoretical) credit risk in this market is so insignificant that we do not monitor it – to do so would entail development of systems and procedures whose costs far outweigh any risk management benefits. Monitoring will only normally occur if a trade failed to settle at settlement date. Therefore, a firm's credit and regulatory systems currently do not measure credit risk associated with DVP trades prior to the scheduled settlement date. To do so will impose significant costs with a minimal, if any, benefit.

Further, under an IRB methodology, firms would have to internally rate their counterparties and exposures. Given the negligible credit risk involved, DVP counterparties are not normally rated[1]. To require these DVP-only counterparties to be internally rated would involve significant cost in terms of credit risk analysis. This cost would be out of proportion with respect to the perceived negligible credit risk present and our history of broker-dealer transactions.

Additionally, and for the reasons above, we support the argument that normally settling DVP trades should be excluded from the calculation. Rather, the focus should be on the inclusion of failed trades subject to an appropriate grace period.

1.4 Repo VaR Backtesting

Our analysis suggests that the relative risk capital contribution of repos may be disproportionate to the cost of backtesting implementation. We would therefore propose that a risk materiality threshold be introduced to justify such an effort.

2 Operational Risk

2.1 Pillar 2 Treatment

We have long advocated that a Pillar 2 Approach is more appropriate for the treatment of Operational Risk. Certain operational risk events, particularly low-frequency high-impact ones, are unsuited to measurement and evaluation. In this regard, the AMA Approach, as currently proposed, will involve a fair degree of subjectivity to derive a reasonable risk capital requirement. In some cases arbitrary decisions will have to be made in the following areas:

- the choice of operational risk categories for some types of risks;
- the adjustments to internal loss data to reflect the changes in business mix; and
- the use of external data to complement internal losses.

2.2 Confidence Interval

As the responses to Basel's CP3 demonstrate, there is a widespread concern that the stated confidence interval, 99.9%, is too onerous given data availability at this stage of development of the operational risk discipline. We have already discussed this topic in our own CP3 response, attached as Appendix 2. Technically, the 99.9% threshold raises two significant issues:

1. Estimating a high quantile with reasonable precision requires very large data samples. In the case of operational risk, the discrete events that create the tail of the loss distribution are infrequent, even after taking into account relevant external data. As a result, the estimated

[1] A rating may exist where that counterparty transacts other non-DVP products with the firm.

unexpected loss can be far from the true 99.9% quantile, especially when using fat-tailed distributions.

2. Mandating a very exacting level of confidence provides a disincentive to include conservatism in the statistical modeling of the loss distribution. This is because as fatter tails are built in the models, the 99.9% quantile quickly produces unreasonably large numbers compared to the 99% quantile adopted for other risks. This disincentive goes against the spirit of other parts of the ANPR that require that a degree of conservatism be included in the analytical framework.

We would recommend that the explicit reference to the 99.9% confidence level be deleted and that the confidence level be selected according to the internal economic capital model used by the firm. Emphasis should be put on the necessary conservatism in the modeling to arrive at a reasonable number when compared to benchmarks (e.g., % of total capital, number of times largest losses incurred).

3 Implementation and need for Transitional Arrangements

3.1 Parallel Running of Basel I Calculations

As with many others in industry, we remain concerned that the need for the effective parallel running of Basel I calculations for at least three years (year prior to implementation and two years after) imposes unnecessary costs on firms. We consider that the further Quantitative Impact Study, expected prior to implementation, together with the results of the parallel implementation period and the functioning of the Pillar 2 regime should provide the Agencies with sufficient knowledge of the macro and firm-specific impact of the ANPR proposals.

3.2 Leverage Ratio

We are concerned that the Agencies continue to view the leverage ratio tripwires contained in existing Prompt Corrective Action regulations as important components of the regulatory capital framework. We consider the leverage tripwire to be unnecessary particularly in light of the greater risk sensitivity of the A-IRB approach and the Pillar 2 role of ensuring that all risks are covered. We believe that an asset-to-capital leverage ratio is overly simplistic and does not reflect the risk profile of assets, hedging strategies, or off-balance sheet exposure and we do not rely internally on overall leverage ratios to assess risk-based capital adequacy.

In particular, the Basel Committee has previously stated, "increased capital should not be viewed as the only option for addressing increased risks confronting the bank. Other means…must also be considered.[2]" The Agencies have acknowledged that in "some" cases the leverage ratio would continue to be the most constraining capital requirement. We think that the leverage ratio may be the most constraining requirement in many cases, which seems to defeat the whole purpose of the Pillar 1 approach. Accordingly, in light of the supervisory review provided for in Pillar 2, and as the Agencies indicated they would do, the appropriate response would be to impose additional capital requirements for individual institutions on a case-by-case basis.

[2] Par. 590 in the Basel Committee's January 2001 CP2 document.

3.3 Impact on Capital Classifications

The ANPR proposes floors that limit the amount risk-weighted assets can decline in each of the first two years of stand-alone usage of the advanced approaches. We have long been proponents of compensating caps or ceilings to minimize the impact where capital increases (see our response to CP3 at Appendix 2).

The powers and activities of U.S. banks are in part determined by their capital classification ('well capitalized', 'adequately capitalized', or 'undercapitalized'). Should a significant increase in risk-weighted assets result from adoption of the advanced approaches, a bank's capital classification could change, resulting in a loss of powers and required regulatory enforcement action. Therefore, we would suggest that the final rule should provide a bank with flexibility to generate sufficient capital over an appropriate transitional period (e.g., two to three years). This would allow a bank to maintain the same capital classification under the advanced approaches as it had prior to adoption of the new capital standards without limiting its activities or becoming subject to regulatory enforcement actions.

3.4 Application to Large Groups

The ANPR states that the Agencies believe all bank and thrift institutions which are members of a consolidated group that is a core bank, or an opt-in bank, should calculate and report their risk-based capital requirements under the advanced approaches. We believe this approach will greatly increase the costs of compliance and provide minimal, if any, benefits. Further, as product lines and activities cross legal entity lines, supervision in many instances has evolved away from evaluation of individual institutions.

We note that the ANPR acknowledges the challenges facing entities in providing meaningful and readily available disclosure for individual institutions in a consolidated group. Therefore, we recommend that second and lower tier entities comply with the advanced approaches only if an entity by itself qualifies as a core bank. Otherwise, adoption of the advanced approaches should be at the option of the institution.

4 Treatment of Goodwill

Recent changes in U.S. GAAP have changed goodwill from an amortizing asset into a permanent one subject to an impairment test. This change recognizes that goodwill has inherent economic value and is not by definition a wasting asset. While we realize such assets are illiquid, we nevertheless believe that it is unnecessarily penal for them to be subject to a 100% deduction from Tier 1 capital, especially given that this severity of treatment could prevent acquisitions which strengthen the overall financial system. We would encourage the Agencies to further consider the appropriate capital treatment of goodwill.

5 Concerns about Data Adequacy

In our response to the Basel Committee's CP3, attached as Appendix 2, we noted that lack of data might give rise to implementation issues. We were concerned that lack of data might act as a barrier to adoption of the advanced approaches. In light of this, we support the language in the ANPR Executive Summary that permits use of external data for business lines where sufficient internal data does not exist to support PD / LGD assumptions. This development is welcome, though we would note that the data issue is not specific to Credit Risk because it affects Operational Risk as well.

Lack of data may be due to positive factors such as minimal loss history, either as a result of underlying market fundamentals (such as for DVP trades discussed earlier) and/or due to robust controls and risk appetite adopted by an individual firm. New products and markets, a healthy sign of an innovative environment, similarly would lack data history.

Firms and markets affected by the circumstances described above would be penalized for their lack of data by rendering the advanced approaches as unobtainable. This would be damaging to the aim of creating a risk sensitive capital framework, as well as to the affected firms and markets themselves.

6 Pillar 3 Disclosures

The Agencies raise questions seeking responses as to the appropriateness of the proposed Pillar 3 Disclosure requirements. In response we wish to note that we support the Principles for Strong Disclosure Practices set out in the Shipley Report ("Working Group on Public Disclosure" report, dated January 11, 2001, to the Fed, the OCC and the SEC). These Principles are founded on the basis that disclosures should be closely aligned to the practices and policies of the individual firm. Thereby disclosures will always be pertinent and relevant. We believe this concept is equally relevant for the Pillar 3 disclosures. In this respect, the disclosures proposed in the ANPR appear to be generally consistent with the Shipley Principles, though this will only be properly determined upon full implementation given the practical slant imbedded in the Principles.

7 Ongoing Dialogue

As we have noted above we remain in active and ongoing dialogue with many Supervisors and Legislators around the world, including the Fed, FDIC, SEC and OTS. Similarly, significant aspects of the proposals are subject to revision, for example Securitization. Therefore, we do not wish our comments set out in this response to be viewed as final or definitive. We would hope that the Agencies would continue to accept relevant and informative commentary on aspects of the ANPR beyond the end of the consultation period.

We hope that you find our comments helpful. We are very happy to clarify and discuss any of the matters in this response. Please feel free to contact us, Steve Teather (+44 (0)207 995 4848 or steve_teather@ml.com), or Nicole Degnan (212 449 5042 or nicole_degnan@ml.com).

Yours sincerely,

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First Vice President
Corporate Controller
Merrill Lynch & Co., Inc.

Christopher B. Hayward
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cc: Michael A. Macchiaroli, Esq.
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Appendix 1

Detailed Comments on ANPR Proposals

Appendix 1: Detailed Comments on ANPR Proposals

We have not sought to answer all the questions posed by the Agencies in the ANPR. Provided below are answers to those questions that are relevant and appropriate to ML, together with other detailed comments.

A. Credit Risk

ANPR Question: *The Agencies seek comment on appropriate thresholds for determining whether a portfolio, business line, or geographic exposure would be material.*

We would suggest thresholds be functions of loss materiality by product, portfolio or business line in combination with thresholds for individual exposure levels. These measures are consistent with our risk management approach philosophy today. We may adopt a less resource intensive approach toward counterparties with exposures below a certain threshold and where such exposure is highly collateralized, short term in nature or for products that by virtue of a high degree of regulation or standardization of market practice, are perceived to be less risky. We would suggest a total threshold for materiality of 1% of total Risk Weighted Assets.

Loss Given Default: We would appreciate clarification from the Agencies that they are not in concept averse to firms using very low LGDs for exposure classes where it can be demonstrated that losses are rare if non-existent, for example, in the retail margin lending business. In many instances the LGDs could tend to zero.

ANPR Question: *The Agencies invite comment on the merits of the SSC approach in the United States.*

We strongly support offering the SSC approach as an option. This affords institutions the flexibility to conduct their own internal cost benefit analyses and take the more simplified approach of mapping internal risk rating grades to one of the five supervisory grades as appropriate, without compromising the overall Advanced IRB approach.

ANPR Question: *The Agencies are seeking comment on the proposed definitions of the retail A-IRB exposure category and sub-category. Do the proposed categories provide a reasonable balance between the need for differential treatment to achieve risk-sensitivity and the desire to avoid excessive complexity in the retail A-IRB framework? What are the views on the proposed approach to inclusion of small business exposures in the other retail category?*

We support the inclusion of SMEs in the other retail category, however we would strongly suggest that the threshold of $1 million in exposure is too low for both SMEs and individuals. We strongly believe that the threshold should be raised to $5 million to be more consistent with the practicalities of our business mix and client base. A material percentage of our individual and SME exposures are between $1 and $5 million. Given these exposures are well collateralized and exhibit common attributes, we would prefer to categorize them on a pooled basis, rather than having to rate each borrower and exposure independently. We acknowledge that $5 million may not be appropriate for all banks, and so the Agencies may consider that thresholds should be determined on a case-by-case basis.

Double default:

The proposal as it now stands provides very little incentive to hedge exposures and gives little benefit for activity that results in substantial credit risk mitigation.

We strongly support the ISDA position response to the ANPR on this topic.

Credit Derivatives:

The formula for maturity mismatch is punitive – hedging of default risk within the one-year horizon is not affected by maturity mismatch when protection is for more than a year. The formula should affect only the hedging benefit with respect to the loss of market value due to spread widening (credit migration).

Additionally, within the substitution approach, risk mitigation achieved by buying credit derivative protection from a counterparty that is rated lower than the reference obligation, but with CSA protection providing credit enhancement (e.g., is collateralized) is completely missed.

B. Operational Risk

Independent Testing and Verification Function:

It is unclear whether internal (audit) staff can fulfill this function.

Quarterly reporting interval:

The regulators prescribe at least a quarterly reporting interval for risk exposures, loss experience, business environment and internal control assessments. Given that we do not expect some of these items to change with such frequency, we suggest that the regulators allow each institution to report quarterly what is meaningful, decide the reporting intervals for all other items, and discuss their rationale for choosing these intervals with the regulators.

Exception reporting:

We would appreciate clarification as to the meaning of this section, which is unclear at present.

Demonstrate appropriate internal loss event data, relevant external loss event data, assessments of business environment and internal controls, and results from scenario analyses:

We suggest that the Agencies provide additional guidance to clarify the relative emphasis to be put on the use of these elements in the management of operational risk (e.g., risk assessments, resource planning and risk mitigation initiatives) or for modeling purposes. If the latter should predominate then it should be explicitly stated that firms have the flexibility to use only certain elements (or combinations of elements) over others. For example, businesses that have enough internal loss data points to build a conservative loss distribution should be allowed to use only this internal dataset.

Event end date:

Given that the date of the loss and the discovery date of the loss are both suggested, it seems to be unnecessarily burdensome to track yet a third date for every data point. The regulators should highlight whether or not this is a mandatory item. If not, to avoid similar confusion by other firms, it might be best to delete it from the "suggested" list.

System to identify and assess business environment and internal control factors:

The agencies should clarify what the key elements of such a system should be. In particular can an institution have different assessment systems in different businesses?

Supervisory standards for removing the Expected Loss Offset in the capital computation:

The guidance should specify what these standards are so that firms expecting to qualify for the offset in their data can meet these standards.

Independent verification of the analytical framework:

We seek clarification that internal audit or another independent, competent area within the firm can perform this independent verification.

Expected Loss offsets and thresholds:

It is unclear why firms with higher thresholds should be penalized with a smaller expected loss offset so long as they demonstrate diligent efforts to capture the tail or "unexpected loss" exposures, particularly if they can show that the threshold is sufficient.

Impact of risk mitigants:

It is not clear why a 20% limit on the impact of risk mitigants was chosen. The recognition of risk mitigation in the operational risk calculations should be left to the institution subject to strict criteria and principles. If a ceiling were maintained then we would ask for clearer guidance on acceptable ways to apply this ceiling in the calculations (e.g., historical vs. prospective basis, loss data offset vs. offset to final capital results).

Future risk mitigation products:

We suggest that the Agencies should provide guidance as to how future risk products introduced by either the insurance industry or capital markets can get an expedient joint review and approvals from all four agencies.

Public reports on operational risk measurement and management results:

Given the sensitive nature of operational risk event information, we would caution against any suggestion that the information should be made available beyond internal reports and regulatory discussions.

AMA computation interval:

We suggest that the computations for determining operational risk capital is updated less frequently than those for either market or credit risk capital. Since a firm's operational risk profile is largely dependent on its senior management, governance processes, and risk-minded culture, we would anticipate that such factors would change much more slowly than the market fluctuations, market positions, and credit exposures that drive the market and credit risk capital computations. If the regulators wish to have regulatory capital requirements timed with the management cycle for determining internal economic capital requirements, then we suggest that this be done annually. Regulators, of course, will retain the option of intra-year updates whenever it appears that a firm may have abruptly altered its profile (e.g., through a strategic restructuring or significant insurance purchase).

Appendix 2

ML Response to the Basel Committee's CP3

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 recognize 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 (summarized 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 Standardized 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 firm. 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
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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.

<u>Credit Risk</u>

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 that 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 summarized 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 standardized linear scaling factor approach is used.

It is essential these matters that relate largely to Trading Book exposures be 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[3]. 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.

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 recognizes 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 recognize 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.

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[3] *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) Standardized Approach = +12%, (2) Foundation IRB = +4%, and (3) Advanced IRB = +2%.*

Securitization

The prescribed risk weightings for securitization 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 securitization tranches, particularly for retail and mortgage portfolios.

We believe that sophisticated banks should be allowed to use models to determine risk capital allocation for securitization 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 securitization exposures in question.

It is necessary to calibrate the Rating Based Approach better to reflect the diversity in securitization. We believe that a set of different risk weights corresponding to different securitized 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 Standardized 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 Standardized Approach. We find it odd that the Committee should crystallize such an incentive. The relatively high standards for the Standardized 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[4] does not suggest that the Trading Book business lines are inherently more risky.

We note the Committee has recognized 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 recognizes 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 institutionalized 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.

[4] *2002 Loss Data Collection Exercise for Operational Risk published by the Basel Committee on 14 March 2003.*

As an alternative we suggest that the betas could be further differentiated by way of "core" versus "non-core" business. Core business would attract a lower beta to recognize 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 recognize 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.

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 state clearly its requirements in respect of data collection and use. Given the ambiguity of the term "bank" in the Accord[5] 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 organization 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.

[5] *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.*