Mellon

Mellon Financial Corporation

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Gentlemen:

I am writing on behalf of Mellon Financial Corporation, Pittsburgh, Pennsylvania ("Mellon") and the Dreyfus Corporation, a long-time mutual fund complex that is a subsidiary of Mellon. Dreyfus offers money market funds (MMFs) to many clients, including insured depositories and related firms that will come under the U.S. Basel II and IA risk-based capital rules. We recognize that your Agencies are working to finalize the US approach to the risk-based capital rules as proposed under Basel II, and have just proposed further revisions. In that regard, we would like to bring an issue to your attention so that it can be addressed by your Agencies at the appropriate time.

Specifically, we would like to draw your attention to provisions in the notice of proposed rulemaking (NPR) on the U.S. Basel rules published in the Federal Register on September 25, 2006. In its treatment of the risk-based capital (RBC) for equities, the NPR (see section 54) addresses "investment funds," which would include MMFs. As discussed in more detail below, we believe this RBC treatment is incorrect with regard to actual MMF risk. Such an approach not only exacerbates the differences between regulatory and economic capital already seriously problematic in the NPR, but also creates perverse incentives to risk mitigation. Accordingly, we urge the agencies to ensure that RBC promotes appropriate risk mitigation and rewards it, rather than creating an invitation to regulatory arbitrage.

The Problematic MMF Proposal

Specifically, Section 54 provides three options for setting RBC for MMFs:

- A full look-through in which RBC is set based on the MMF holdings as if these were directly held by a bank, which should obviate the alternative of a "hair-cut" that may add additional RBC;
- A modified look-through that sets RBC based on the highest risk weight asset the MMF is permitted to hold or the alternative of a hair-cut; or
- A modified alternative look-through, in which RBC is based on MMF holdings, reflecting hedge relationships and other factors. There would not be a haircut, but RBC weightings for all assets in the MMF could not be less than 7%.

As you may know, MMFs are carefully regulated and thus very different from the many types of investment funds addressed in Section 54. In contrast to private equity funds, hedge funds or similar vehicles, MMFs must be registered with the Securities and Exchange Commission under Rule 2a-7 (12 CFR 270.2a-7). As a result, MMFs are fully liquid, high-quality investments largely used by banks and other investors as a cash alternative for liquidity management, not as a source of investment-driven earnings. Reflecting this, all of the proposed MMF approaches are problematic as follows:

- The full look-through would be very burdensome and quite inappropriate, requiring bank investors to track MMF holdings on a constant basis and then incur the considerable burden of estimating probability of default, loss given default and all the other factors that determine RBC.
- The modified look-through addresses the burden question. However, by setting the RBC weighting at the highest, that is, the riskiest asset that the MMF can hold under its "prospectus, partnership agreement or similar contract that defines the funds' permissible investments", it misrepresents the actual risk. It may further create an incentive for banks to invest in MMFs with the highest-risk positions possible under Rule 2a-7 in an effort to make the actual risk of their MMF holdings better comport with the regulatory risk-based capital requirement.
- The proposed minimum risk weighting in the modified alternative approach also creates an incentive for higher-risk holdings. An MMF investing only in sovereign AAA-rated obligations would theoretically be eligible for a zero-percent risk weighting absent this minimum. With the minimum, banks may again seek higher-risk MMFs to minimize the variance between regulatory and economic capital.

The haircuts and other limitations thus create a problem germane to all of the proposed approaches: incentive for risk-taking. By virtue of these unduly punitive RBC approaches, the proposal creates an incentive for banks not to hold MMFs with diversified positions in high-quality assets, but rather to take large positions in individual obligations. This could exacerbate the concentration risks related to current holdings of obligations such as those issued by the government-sponsored enterprises. This could add additional concentration, liquidity and credit risk to the banking system, undermining the value now derived from MMFs.

Recommended Solution

We suggest the following two alternatives for MMFs:

- Under Basel II, banks could determine the RBC for each MMF holding, reflecting the full range of assets in the MMF, the related correlation risk and other factors determined by appropriate internal models. Regulators would review these RBC determinations and, if desired, require additional capital allocation under Pillar 2 if, for example, a bank has so large an investment in a single MMF that concentration risk related to it may be evident; or

- Under Basel IA, RBC would be based on the highest-risk asset held by the MMF, with no applicable haircut. The simplicity of this approach is desirable, despite the remaining incentive for potentially higher-risk MMF holdings.

We would be pleased to discuss these options in greater detail or provide any additional information or assistance.

Yours sincerely,

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