



STATE STREET.

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Office of the Comptroller of the Currency  
250 E Street, SW  
Mail Stop 1-5  
Washington, DC 20219  
Docket Number OC-2007-0004  
[regs.comments@occ.treas.gov](mailto:regs.comments@occ.treas.gov)

Jennifer J. Johnson, Secretary  
Board of Governors of the  
Federal Reserve System  
20th Street and Constitution Avenue, NW  
Washington, DC 20551  
Docket Number OP-1277  
[regs.comments@federalreserve.gov](mailto:regs.comments@federalreserve.gov)

Robert E. Feldman  
Executive Secretary  
Attn: Comments/Legal ESS  
Federal Deposit Insurance Corporation  
550 17th Street, NW  
Washington, DC 20429  
Re: Basel II Supervisory Guidance  
[comments@FDIC.gov](mailto:comments@FDIC.gov)

Regulation Comments  
Chief Counsel's Office  
Office of Thrift Supervision  
1700 G Street, NW  
Washington, DC 20552  
Docket Number 2007-06  
[regs.comments@ots.treas.gov](mailto:regs.comments@ots.treas.gov)

Dear Sir or Madam:

State Street Corporation appreciates the opportunity to comment on the "Proposed Supervisory Guidance for Internal Ratings-Based Systems for Credit Risk, Advanced Measurement Approaches for Operational Risk, and the Supervisory Review Process (Pillar 2) Related to Basel II Implementation" (the "proposed supervisory guidance") published by the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision (collectively, "the Agencies") on February 28, 2007.

Headquartered in Boston, Massachusetts, State Street specializes in providing institutional investors with products and services related to investment servicing, investment management and investment research and trading. With \$12.3 trillion in assets under custody and \$1.8 trillion in assets under management as of March 31st, 2007, State Street operates in 26 countries and more than 100 markets worldwide. As a global institution, we expect to adopt Basel II in numerous markets, including the U.S., Germany, Japan, Canada, Luxembourg, the United Kingdom and France.

As described in our comments to the Agencies on the Basel II Notice of Proposed Rulemaking (the “NPR”) on March 26, 2007, State Street believes several important changes should be made to the proposed U.S. adoption of Basel II, including flexibility to allow a phased approach to the qualification process for U.S. banks, the option to use the Standardized Approach and, in general, closer alignment with the international Basel II agreement. Such changes will result in a more efficient and effective implementation of Basel II for U.S. banks, and minimize potential competitive disadvantage for U.S. banks.

While we do not repeat at length our March 26 comments here, we note that many of our suggested changes would also require corresponding changes to the proposed supervisory guidance. Comments on several issues related to the proposed supervisory guidance follow below.

### **Internal Ratings-Based Systems for Credit Risk**

We note that the proposed supervisory guidance is an improvement over the Agencies’ previous similar proposals. In numerous areas, however, we believe the approach is overly prescriptive, and we suggest the Agencies adopt a more principles-based approach. These issues are discussed at length in comments filed by the Risk Management Association’s Capital Working Group (CWG) and the American Bankers Association (ABA), and we generally associate ourselves with the views expressed by these trade associations.

### **Advanced Measurement Approaches for Operational Risk**

Similarly, there are numerous areas of the proposed guidance related to the Advanced Measurement Approaches for Operational Risk which we believe are overly prescriptive. We urge the Agencies to recognize, throughout the supervisory guidance, the relative immaturity of operational risk measurement, and establish regulatory procedures and expectations sufficiently flexible to accommodate emerging approaches to operational risk management. For example, there is currently no industry consensus on methodology for combining the four required elements of a bank’s data and assessment systems supporting its AMA system described in S-11 and S-12 of the proposed operational risk guidance. Regulators should provide banks flexibility in adopting such methodologies, provided the approach chosen reasonably covers all operational risk exposures.

In general, we associate ourselves with the detailed comments and suggestions provided to the Agencies by the Advanced Measurement Approaches Group (AMAG) of the Risk Management Association.

### **Governance**

We agree with the Agencies’ view that the board of directors’ “strategic direction and oversight is essential to effective advanced systems.” We are concerned, however, that both the proposed supervisory guidance and the NPR place undue, often highly

technical responsibilities on the board --- responsibilities more reasonably assigned to senior management.

For both credit and operational risk, the supervisory guidance includes numerous instances where the board is required to evaluate, approve, or otherwise pass judgment on highly technical systems and processes.

For example, for both credit risk and operational risk the supervisory guidance and the NPR require annual evaluation and approval by the board of directors of the bank's advanced approaches. As described by the Agencies, this requirement could be interpreted to create a highly technical, detailed, and onerous responsibility for the board of directors, which, perhaps, would require retention of independent outside consultants. The responsibility for performing this evaluation would be more appropriately delegated to senior management and audit, reporting findings to the board of directors. In addition, the frequency of such evaluations should be risk-based, rather than prescribed annually, as required by the proposed supervisory guidance.

We urge the Agencies to limit board responsibilities to oversight and strategic matters, to clearly delineate the respective roles of senior management and the board, and to permit delegation by the board of responsibility where appropriate.

## **Validation**

We agree with the importance of a rigorous and independent model validation process, and support most of the principles outlined in the proposed supervisory guidance related to model validation.

In several areas, however, we believe the proposed supervisory guidance for credit and operational risk model validations is either overly prescriptive or excessively onerous. For example, the credit risk requirement under S7-14 establishes highly prescriptive requirements for the validation policy related to remedial actions for instances where model results and actual outcomes fall outside of certain ranges. Mandating inclusion of such information in a validation policy is overly prescriptive. Similarly, the proposed guidance, as part of a bank's justification for selecting approaches, mandates a discussion of other alternatives considered. Here again, a more flexible approach is appropriate, and the discussion should be a recommendation rather than a requirement.

We refer the Agencies to the comments filed by the CWG, the AMAG, and the ABA for further detail and examples of overly prescriptive requirements related to the validation process.

Overall, we suggest the supervisory guidance establish concepts and principles that the validation policy should address, and allow more detailed matters to be addressed on a model-specific basis, outside of the policy.

## Pillar 2/ICAAP

We appreciate the Agencies' development of workable, principles-based guidance for the Internal Capital Adequacy Assessment Process (ICAAP). We urge the Agencies to maintain this approach in the final guidance, and apply a similar approach to other sections of the supervisory guidance.

There are some areas, however, where the proposed guidance could be improved. For example, the statement in paragraph 7 that "supervisors generally expect banks to hold capital above their minimum regulatory capital" could suggest that the primary goal of Pillar 2 is to establish the level of required capital in excess of Pillar 1 a bank must hold, rather than establishing the requirement for a bank to assess its own capital adequacy, and align capital with risk. We suggest that the proposed guidance be revised to acknowledge that, in some cases, the level of economic capital held in excess of the regulatory minimums is a business rather than regulatory decision, driven by a host of considerations, as dictated by the customers and markets served by the bank.

In other areas, an ICAAP can address risks not requiring specific capital assessments. For example, the risk management principles laid out in the proposed supervisory guidance for liquidity risk are well-founded, and consistent with State Street's global liquidity risk management process. However, liquidity risk – the ability to meet all present and future cash obligations in a timely and cost-effective manner -- is best managed through balance sheet and funding plans, not capital. We are concerned that an overly prescriptive reading of the proposed supervisory guidance could lead supervisors to seek a specific capital assessment for liquidity risk in a bank's ICAAP process, and comment negatively when not finding this risk-type.

We suggest the Agencies use caution in prescribing increased capital as an expected outcome of the Pillar 2 process. As noted in many comment letters to the Agencies on the NPR, the U.S. Pillar 1 proposal already contains many conservative assumptions and limits, often well beyond those required under the global Basel II agreement. For example, the proposed retention of the leverage ratio, a capital requirement nearly unique to the U.S., could ultimately be the most relevant regulatory capital minimum for many U.S. banks adopting the U.S. Advanced Framework.

Finally, we urge the Agencies to adopt a sufficiently flexible implementation of Pillar 2 to permit maximum alignment of the regulatory process with banks' internal capital self-assessment processes. A bank's ICCAP needs to be flexible enough to react to changes in the financial markets, product innovations, and improvements in operational risk measurement techniques. We generally agree with the ICAAP principles described by the Agencies, but urge the Agencies to focus on applying these principles to internal self-assessment processes selected by banks, rather than dictating specific requirements banks must adopt.

## Qualification Process

In our comments on the NPR on March 26, we suggested the Agencies adopt a flexible, phased approach to qualification for the credit and operational risk advanced approaches. While the qualification process and transition to Basel II are generally not the subject of the proposed supervisory guidance, these are critical issues where additional guidance is necessary, and we repeat, in brief, our views here.

First, we urge the Agencies to adopt credit and operational risk qualification standards which permit phased or partial adoption of the new approaches. Under the global Basel II agreement, banks are permitted, on either a transitional or, in some cases, permanent, basis to adopt the advanced approaches for some asset classes or business lines, while using less sophisticated (and more conservative) approaches for other asset classes or business lines. We suggest the Agencies adopt a similar approach.

Second, we suggest the Agencies provide greater clarity regarding regulatory expectations related to the qualification process, for both the Parallel Run and the three subsequent transition periods. As noted in our March 26 comment letter, we are concerned that the language in the NPR appears to suggest that the parallel run period can only begin when a supervisor determines that a bank is fully compliant with all of the qualification requirements for the A-IRB and the AMA. We believe a more flexible approach is appropriate, permitting commencement of a parallel run period while allowing some activities, as identified in a formal board approved implementation plan, to be completed during the parallel run. We urge the Agencies to clarify that such an approach to qualification is permitted.

Once again, we appreciate having the opportunity to comment on the proposed supervisory guidance. We urge the Agencies to act expeditiously to issue final rules and supervisory guidance for Basel II implementation which conform to the global Basel II agreement, and adopt a flexible, principles-based approach to the advanced approaches for credit risk, operational risk, and the Pillar 2 process.

Sincerely,

A handwritten signature in black ink, appearing to read 'Stefan Gavell', written in a cursive style.

Stefan Gavell