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Mellon Financial Corporation

Michael E. Bleier
General Counsel

August 3, 2004

Mr. Edward C. Ettin
Deputy Director
Division of Research & Statistics
Board of Governors of the Federal Reserve System
20th and C Street, NW
Washington, DC 20551

Dear Ed:

Thank you for your letter of July 21 acknowledging our proposal regarding a more flexible Pillar 1 approach for the credit exposure of "specialized institutions." In addition, you have asked for our thoughts regarding the competitive equity of implementing our proposal with respect to other entities subject to thecurrent Pillar 1 proposal for credit risk.

We believe that our proposed modified credit approach will work for banking organizations that have significant amounts of fee-based revenue and a robust system of controls and processes for credit risk. At the same time, our proposal creates an incentive for those institutions with limited credit exposures to reasonably determine what is an appropriate amount of capital without overburdening them with systems and models that are best employed at institutions that are more focused on credit. Moreover, it is difficult to assess the competitive impact of our proposal because of the unknown number of specialized, fee-based banks that have informed the Federal Reserve of their desire to opt in to Basel II. However, we believe that the proposal creates appropriate incentives for them, as well as for any relevant core banks, to review their credit positions and, if desired, reduce and/or improve them to achieve the benefits of Basel II without an undue cost burden associated with small, high quality credit risk positions.

We appreciate the willingness of staff to consider our views on this important issue.

Very truly yours,

Michael

Michael E. Bleier

cc: Honorable Roger Ferguson
Roger Cole
Kevin Bailey
Joseph Abdelnour
Linda Cunningham
Norah Barger

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Michael E. Bleier
General Counsel

July 13, 2004

Mr. Edward C. Ettin
Deputy Director
Division of Research and Statistics
Board of Governors of the
Federal Reserve System
20^{th} & Constitution Avenue, NW
Washington, DC 20551

Dear Mr. Ettin:

Mellon has been encouraged in many ways over the past few months regarding the anticipated U.S. regulatory response to Basel II credit issues. We are pleased that the U.S. regulators have pushed back the implementation of A-IRB an additional year to 2008, allowing the US banking industry more time to work on this significant challenge. Mellon is pleased that the staffs of the Federal Reserve Board and the OCC appreciate the difficulties facing non-core banks in developing the robust data and systems required to become Basel II compliant. We understand that the regulators plan to be flexible and helpful in this regard. Moreover, Mellon looks forward to an opportunity to participate in the upcoming QIS4 study.

Mellon has evaluated its loan portfolios and data in more depth; received feedback from consultants; established a dedicated team with significant quantitative analysis expertise to work on Basel II credit; and is working with external consultants and making systems enhancements. As a result, Mellon believes the effort will lead to both internal risk management improvements as well as Basel II compliance. All of this effort has confirmed our belief in the need for some regulatory flexibility on Basel II credit issues.

As you know, Mellon has long advocated flexibility under a Pillar 1 approach for the credit portfolios of "specialized institutions," given the potentially unbalanced cost-benefit aspects of A-IRB for such institutions. A "specialized institution" (which would include an insured depository, a BHC and a FHC) is one that is predominantly focused on activities like asset management and asset servicing and, thus, has a loan portfolio whose composition and risk profile are not consistent with U.S. banking industry norms.

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We have attached a proposed definition of "specialized banks" that we think will clearly differentiate between these institutions and others, preventing any potential abuse of a more flexible credit risk option. As you will see, we base part of the test on the relationship between loans and total assets. Mellon recognizes that this on-balance sheet approach could permit some institutions to move substantial assets off-balance sheet in hopes of using this simpler approach. Since an institution would be deemed "specialized" only upon a determination by its primary regulator, any such instances could be quickly identified and any such banks required to use Basel II in full.

The treatment we propose for credit risk at specialized banks would require that a materiality threshold be applied to determine eligibility for a more simple approach to credit risk-based capital. Assuming that a financial institution's capital allocation models are acceptable to the regulatory agencies, materiality would be a function of the economic capital allocated to an asset class in relation to total economic capital (based on a rolling 12-quarter average percentage). A capital threshold of 3% to 5% is proposed given the low probability that an entire asset class would default. Mellon believes that this approach is a very conservative way to assess materiality. Materiality is often defined in Basel II as a 10% criterion.

Non- material asset classes would not be subject to A-IRB modeling, but could be treated under the Standardized or F-IRB approach. Asset classes above the materiality standard, however, would be subject to the A-IRB approach. Regulators and institutions will have to work together and exercise judgment as to what constitutes an "asset class."

Mellon appreciates this opportunity to provide input on Basel II credit issues. With regard to operational risk issues, our position remains unchanged. Mellon believes strongly that a Pillar 2 approach to operational risk is the most appropriate regulatory framework. We look forward to further opportunities to provide input on the vital issue of Basel II implementation.

Again, thanks for your willingness to hear us out on this issue.

Yours sincerely,

Michael E. Bleier

Attachment

cc: Honorable Roger Ferguson
Roger Cole
Kevin Bailey
Joseph Abdelnour
Linda Cunningham
Norah Barger

EttinFRBLet.doc

Attachment

Specialized institutions (a term used in QIS 3), are those which have non-significant business units and/or asset classes from an economic capital perspective. A specialized institution would include a Bank Holding Company (BHC) and a Financial Holding Company (FHC). Such an institution would be predominantly focused on activities like asset management and asset servicing rather than lending.

We propose the following qualification criteria (using available and comparable public regulatory reporting data), in order for a consolidated institution to qualify for non A-IRB treatment for certain non-significant credit portfolios:1. Average Total Loans[1] must be less than 25% of Average Total Assets[2] on a rolling twelve quarter average basis, and

2. Net Interest and Fee Revenue on Loans and Lease Financing Receivables[3] must be less than 10% of Total Net Revenue[4] on a rolling twelve quarter average basis, and

3. Net Credit Losses[5] must be less than 5% of Total Net Revenue[4] on a rolling twelve quarter average basis.

4. Capital allocation models must be acceptable to the FED, OCC and FDIC, as applicable.

1. FR Y-9C Schedule HC-K - Quarterly Averages, line 3 (Loans and Leases)
2. FR Y-9C Schedule HC-K - Quarterly Averages, line 5 (Total Consolidated Assets)
3. FR Y-9C Schedule HI - Line 1a. plus line 1 b., as a % of line 1 h., multiplied by line 3 (Interest and Fee Income from Loans and Leases divided by Total Interest Income times Net Interest Income)
4. FR Y-9C Schedule HI - line 3 plus line 5 m. (Net Interest Income plus Total Non Interest Income)
5. FR Y-9C Schedule HI-B line 9, Column A minus B (Charge Offs minus Recoveries)