October 31, 2003

Office of the Comptroller of the Currency
250 E Street, S.W.
Public Information Room, Mailstop 1-5
Washington, D.C. 20219

Attention: Docket No. 03-14

Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, D.C. 20551

Attention: Ms. Jennifer J. Johnson, Secretary
Reference: Docket No. R-1154

Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, D.C. 20429

Attention: Robert E. Feldman, Executive Secretary
Reference: Comments

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

Attention: No. 2003-27

RE: Advance Notice of Proposed Rulemaking
Risk-Based Capital Guidelines; Implementation of New Basel Capital Accord

Dear Sir or Madam:

Mellon Financial Corporation, the parent of Mellon Bank, N.A., Pittsburgh, Pennsylvania, appreciates the opportunity to comment to 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 the Advance Notice of Proposed Rulemaking (the "ANPR").

Mellon Financial Corporation (Mellon) has a number of concerns with the Basel II Accord, and with the proposed U.S. rules and standards laid out in the ANPR. The most significant concerns for Mellon continue to focus on an explicit Pillar I capital charge for operational risk, its inapplicability to many of our competitors and the limited recognition of mitigants other than capital for operational risk.

The provisions of Basel II and the rules and guidelines considered by the ANPR, are unnecessarily complex. This degree of complexity will lead to a number of problems;

inconsistency in the definition and enforcement of international regulatory standards, difficulties for banks in interpretation of regulations, and the risk of non-comparable (and potentially misleading) information being provided to third parties under Basel disclosures. The Accord and the ANPR attempt to imply a level of precision in determining capital that, in reality, does not exist.

The provisions of Basel II, and the rules and guidelines considered by the ANPR, are too prescriptive in nature. Institutions and regulators have limited opportunities for the exercise of reasoned business judgment in such a rule-based approach. The ANPR should allow institutions to make distinctions relating to the degree of risk and materiality in credit portfolios and operational processes. With such an approach, an institution and its regulators would have the flexibility to engage in cost effective risk management. The ANPR rules do not fully allow differentiation of high quality or low dollar size credit risk portfolios. Similarly, a Pillar II approach to operational risk should allow the needed flexibility.

We support the intent of the Agencies to ensure that boards of directors and senior management take responsibility for appropriate risk management. However, the involvement and responsibility of the board must be balanced with the fact that bank directors have numerous responsibilities, including those increasingly related to ensuring appropriate corporate governance safeguards are in place and working. The ability of directors to set policy and to ensure that management adheres to it is undermined if directors must at each meeting review lengthy and detailed mandated reports. Buried in detail that is best delegated to management, boards can become unable to spot key emerging risks and address them. The board or a designated committee should approve and periodically review the bank's operational risk management framework; the design, implementation, operation and monitoring of a risk management system should be within management's duties. The board of directors should be kept informed of material issues as they arise, with periodic reports as appropriate.

The Agencies refer to the capital requirements currently in place in the United States under Prompt Corrective Action legislation, specifically the leverage requirement. We believe the U.S. banking regulators should consider the elimination of the leverage capital ratio in conjunction with the adoption of Basel II. The leverage ratio is fundamentally incompatible with an advanced, risk-based capital regime. The primary purpose of adopting Basel II is to introduce a broader menu of risk weightings for different asset categories. This is in response to the single largest criticism of Basel I, that there were too few risk categories and that loans to triple-A rated corporations carried the same risk weighting as sub-prime consumer loans.

The leverage approach, where all assets are risk weighted identically, is an additional step backward even from Basel I. Further, there is no provision in the leverage approach for capitalizing off-balance sheet risks. It appears that the leverage ratio, like the Pillar 1 ORBC requirement, exists solely to impose a "floor" on the amount of equity capital that Banks and FSHC's are required to maintain. If that is indeed the case, it makes no sense to require institutions to spend tens of millions of dollars for advanced measurement

systems and then to have the results of those measurements essentially thrown out by having the leverage ratio become the minimum capital standard.

The Agencies have indicated that U.S. banks adopting Basel II capital standards, may only adopt the Advanced Internal Ratings Based (A-IRB) approach to credit risk, and the Advanced Measurement Approach (AMA) to operational risk. This limitation has implications for overall bank capital, the soundness of the banking system, and the ability of regulators in the field to appropriately assess minimum capital standards. Limiting U.S. banking institutions to these two approaches will lead to international inequality, as non-U.S. institutions may pick from three credit approaches, and three operational risk approaches.

Operational Risk Capital

Due to the numerous problems inherent in the Accord, which we outline below, a Pillar II approach (which contemplates regulators working with institutions to best understand and dimension operational risks) provides a much more workable solution to the determination of required capital.

- Basel II will result in an incremental capital charge for operational risk, which in the case of specialized trust and processing banks, will not be offset by a reduction in required capital for credit risk.

- Since many of the competitors of specialized trust and processing banks will not be subject to the Accord, such a capital charge imposes an unfair competitive burden.

- The Accord introduces arbitrary constraints on risk mitigants.

  - Insurance, which is an appropriate mitigant to unexpected losses in all areas of commerce, is inappropriately limited to 20%. Further, the one-year time limits imposed on insurance recoveries is problematic as well.

    - The one-year time limitation fails to consider the timetable of commercial litigation. Frequently the determination of loss amount, and insurance recovery, is not determinable until a date well into the future.

    - Institutions should be allowed to model loss data taking into account their insurance coverages and recovery histories, bound by neither an arbitrary percentage limit, or time of recovery limitation. Taking these factors into account provides a realistic approach to the degree of risk that exists in any loss situation. Modeling of losses and recoveries should of course be subject to review and signoff by the institution's banking regulators.

- Stable, recurring fee based earnings for businesses that do not also contain credit or market risk should be considered as a mitigant for unexpected losses in other businesses.

- Most U.S. institutions can benefit from significant tax savings associated with operational losses, via charges in the current year, as well as loss carry back and carry forward. Failure to consider loss data on an after tax basis overstates the impact of modeled losses.

- Operational risk capital is required for expected and unexpected losses; it should only be required for unexpected events. At Mellon, expected operational losses are incorporated into the business planning cycle.

- There is limited evidence that operational risk can be modeled accurately and with any predictive power. This is further exacerbated by the requirement of modeling operational risk capital at the 99.9% confidence level. A confidence level of 99% is more appropriate. This confidence level is typically used in Value at Risk calculations for modeling market and interest rate risk.

- Imposing a requirement that models be run quarterly is unduly burdensome. The frequency of analysis should be in the discretion of the institution in consultation with its principal regulator.

Operational risk data for external events is not a reliable or even relevant indicator of the future and also does not contain critical root cause or scalar information. Most institutions lack significant internal data – due in large part to their success in running effective operational units. External loss data only reflects the largest losses. This overstates the severity of loss distributions. When only large losses are modeled, this calls for a higher level of capital due to the severity of the presumed distribution.

Balance Sheet Issues

The ANPR seeks to impose risk based capital rules on institutions whose balance sheets vary greatly in terms of size, quality and liquidity. Where the asset type considered is either small in comparison to the overall capital structure of the institution, is of high quality, and/or is extremely liquid, such assets should not be subject to the burden of new control and system requirements.

- For instance, very liquid assets such as investment grade securities, intrabank deposits, money market investments, etc., with low credit risk, should require controls commensurate with their risk.

- Such assets, including bank investment securities portfolios should not fall subject to requirements for additional systems and controls, which are not sensitive to the degree of risk posed by an asset type.

- Within the credit portfolio, where loan assets or commitments are publicly rated, the systems and controls should be commensurate with the level of risk in the portfolio.

Credit Risk Capital

Mellon has examined the credit risk components of Basel II and the ANPR. The size and quality of our credit portfolio do not merit exhaustive modeling and review of the proposed rules. Nonetheless, there are numerous elements of the ANPR that require our response.

- The A-IRB approach to credit risk is not an appropriate solution for institutions where credit risk exposure is not a large risk. Investment in such models should not be necessary for institutions whose primary focus is in the trust and processing businesses. On the other hand, merely reverting to a Basel I approach is hardly an enhancement in risk management. Mellon thus proposes below several ways to address this problem.

- The A-IRB approach also has a number of shortcomings that will make the jobs of regulators and field examiners more difficult.

  - As the determination of the appropriate capital amount is left to each institution and its regulator, it is possible for two institutions holding exactly the same asset to hold differing capital amounts against that asset. With many institutions holding the same assets, in a shared national credit environment, this result is not appropriate.

  - This result reveals the likelihood that many banks will be motivated to understate their capital needs, through the use of complex models.

  - Due to the difficulties in adopting an A-IRB approach (at the individual bank, and system wide level) we believe that over time, the U.S. will (as examiners in charge compare credit allocations for the same loans at their various institutions) move to an approach similar to the Foundation Internal Ratings Based Approach (F-IRB). (Here regulators will establish the inputs for loss given default, exposure at default, and remaining maturity, with banks determining probability of default for their individual loans and portfolios.) If definition of the reasonable range for these variables is inevitable, why shouldn't the F-IRB be an option from the onset?

  - In the case of Shared National Credits, the probability of default should be determined at the agent bank for all institutions in the bank group.

- In light of these issues, we believe U.S. institutions should be able to choose the Standardized, F-IRB or A-IRB approach to credit risk.

- Were the Agencies to proceed with the adoption of the Basel Capital Accord, we believe that the mandated use of the A-IRB approach in conjunction with the AMA for operational risk poses a significant cost burden and disincentive for trust and processing banks. With this in mind, we believe the Agencies should consider a more appropriate structure for non-credit intensive banks, as shown in the two modified approaches to credit risk capital below:

  Option 1: Permit Selection of Either Basel I, Standardized or Foundation IRB for Credit with AMA for Operational Risk.

  - Benefits

    - Provides a simplified approach for banks that have a constant to improving credit risk profile with portfolios or that have stable to declining exposure levels.
    - More cost effective for Banks.
    - Maintains a level playing field for asset management focused banks.
    - Permits institutions to properly allocate resources to the areas of greatest risk.

  Option 2: For Credit IRB, at the Portfolio Level and Applied to Exposure, Use a Materiality Threshold of 100% of Total Capital (subject to rolling five year average credit losses in those portfolios being less than 1% of net operating income before tax).

  - Benefits

    - Balances the Accord principle of requiring increasing sophistication in risk management tools and technology for larger credit portfolios with material exposure levels at risk.
    - More cost effective for Banks.
    - Maintains a level playing field for asset management focused banks.
    - Permits a phase in period for growth portfolios.
    - Permits institutions to properly allocate scarce resources to the areas of greatest risk.

Within the ANPR, the Agencies posed numerous questions regarding the A-IRB approach to credit risk and credit capital allocation. Notwithstanding our strong objections described above, we have examined a number of these points, and our responses are contained in Attachment 1. We have not commented on a number of issues for which we do not have material exposure, such as securitizations.

Market Discipline

The Agencies provide a discussion of Pillar III disclosure issues in the ANPR. This appears to be cursory in nature, and we would anticipate more detail in the proposed rules at a later time. We remain concerned that such mandatory disclosure is dangerous to the banking industry.

- Although we feel it is appropriate to openly share risk information with our regulatory agencies, and have and will continue to do so, the requirement for mandatory disclosure of detailed risk capital elements is not appropriate.

  - Although providing this information might foster a greater level of transparency, it is questionable how individuals and other entities would comprehend or use that information. Banking institutions in the United States already provide substantial disclosures of financial information, and it is our perception that additional mandatory disclosure is not warranted.

  - Wide scale disclosure as contemplated will lead to confusion among users of that information. Although banks would disclose their loan portfolio composition in gross terms, the underlying portfolios themselves may be radically different – especially in the higher risk and unrated categories.

  - This problem is further compounded by the high likelihood of an uneven playing field for many banks. Non-bank competitors, not subject to this level of disclosure may well be advantaged in terms of the public's perception. At a minimum, their cost structure for reporting compliance would be significantly less.

- Public access to risk/loss information can have a number of consequences, including inappropriate use of the information for competitive purposes and used against banks by class action lawyers. Raw data is prone to misinterpretation. Some losses, which may have reasonable explanations or which resulted from problems that have been remedied, might require the organization to defend its data in numerous forums, including responding to RFPs and securities analysts. Such open dialogues might jeopardize confidence in the banking system in general, if not in specific institutions, by artificially heightening concern and focusing the debate on matters that might otherwise not be of concern to experienced regulators. Also, disclosure of such information might provide a roadmap for litigators, particularly the class action bar, thus exposing the banking industry to unwarranted litigation with its attendant expense and reputation risks. This information would establish a floor for negotiations and always result in increased cost for the bank.

- As a result of the options presented to institutions under Basel II, data will rarely be comparable from institution to institution. This results because of a diversity of models that will be utilized among different institutions. Diverse models, using

varying assumptions, will yield a broad distribution of results. Data from those models is not comparable, and will be misleading to those who try to compare it.

- Mandatory disclosures such as those set forth in the ANPR should be eliminated. Principles for disclosure in lieu of prescriptive rules would be less burdensome, and more appropriate to banks and third party users of that information.

We thank you for the opportunity to comment on ANPR. If you should have any questions about our comments or would like to discuss them further, please call Michael Bleier, General Counsel, at 412-234-1537.

Sincerely,

Steven G. Elliott
Senior Vice Chairman
Mellon Financial Corporation

FAX and Email distribution list:

Office of the Comptroller of the Currency
Attention: Docket No. 03-14; fax number (202) 874-4448; or Internet address: regs.comments@occ.treas.gov.

Board of Governors of the Federal Reserve System
Attention: Ms. Jennifer J. Johnson, Secretary
Reference: Docket No. R-1154

regs.comments@federalreserve.gov., or faxing them to the Office of the Secretary at (202) 452-3819 or (202) 452-3102.

Federal Deposit Insurance Corporation
Attention: Robert E. Feldman, Executive Secretary
Reference: Comments

Facsimile transmission to (202) 898-3838 or by electronic mail to Comments@FDIC.gov.

Office of Thrift Supervision

Facsimiles: Send facsimile transmissions to FAX Number (202) 906-6518, Attention: No. 2003-27. E-Mail: Send e-mails to regs.comments@ots.treas.gov, Attention: No. 2003-27, and include your name and telephone number.

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Page(s)	**Issue**	**Specific Question(s)**	**Comment(s)**
22 FR45904	I. Executive Summary C. Overview of U.S. Implementation Other Considerations	With regard to the boundary between the trading book and the banking book, for institutions subject to the market risk rules, positions currently subject to those rules include all positions held in the trading account consistent with GAAP. The New Accord proposed additional criteria for positions includable in the trading book for purposes of market risk capital requirements. The Agencies encourage comment on these additional criteria and whether the Agencies should consider adopting such criteria (in addition to the GAAP criteria) in defining the trading book under the Agencies' market risk capital rules. The Agencies are seeking comment on the proposed treatment of the boundaries between credit, operational, and market risk.	*Agree with the general rule on credit/operational boundary proposal as long as the application remains consistent with GAAP.* *The criteria for inclusion in the trading book should be consistent with GAAP. Introducing parallel monitoring of a trading book defined by additional and different criteria adds undue burden. For example, the New Accord's trading book criteria would permit a hedge that "materially" offsets the risks of another trading book position or portfolio. We conclude that the location of the hedged materially offset position/portfolio (trading book vs. banking book) has little bearing on the capital required to support the market risk of the hedge itself – certainly not enough bearing to warrant a distinct accounting system in addition to and concurrent with GAAP.*
28-29 FR45906	I. Executive Summary D. Competitive Considerations	The Agencies are interested in commenters' views on alternatives to the advanced approaches that could achieve this balance, and in particular on alternatives that could do so without a bifurcated approach. The Agencies are committed to investigate the full scope of possible competitive impact and welcome all comments in this regard. Some questions are suggested below that may serve to focus commenters' general reactions. More specific questions also are suggested throughout the ANPR. These questions should not be viewed as limiting the Agencies' areas of interest or commenters' submissions on the proposals. The Agencies encourage commenters to provide supporting data and analysis, if available.	*Basel II will have a negative impact on competitiveness in a number of ways. First, from a bank to bank perspective, it is a given that only the largest institutions will be able to afford the implementation and on-going maintenance costs of the advanced methods of Basel II and thus obtain favorable capital treatment. Furthermore, from a reputation perspective, banks that are able to adopt A-IRB/AMA will be viewed as more sophisticated in terms of risk management. This will be used as a competitive marketing advantage. Second, from a global perspective, certain regions/countries have voiced significant concerns with the implementation of Basel II. If this continues, US banks will be at a disadvantage in that they will have devoted significant resources to Basel II implementation and be forced to compete with international institutions that have not, and furthermore may not be constrained by the Basel capital requirements. Third, institutions that are outside the scope of regulation are and will continue to be in an advantageous competitive and supervisory positions. Last, since the accord may be capital neutral for the large money center banks, they will be competitively advantaged against the processing center banks for which the Accord is not capital neutral.*

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Page(s)	**Issue**	**Specific Question(s)**	**Comment(s)**
28-29 cont'd. FR45906	I. Executive Summary D. Competitive Considerations	What are commenters' views on the relative pros and cons of a bifurcated regulatory framework versus a single regulatory framework? Would a bifurcated approach lead to an increase in industry consolidation? Why or why not? What are the competitive implications for community and mid-size regional banks? Would institutions outside of the core group be compelled for competitive reasons to opt-in to the advanced approaches? Under what circumstances might this occur and what are the implications? What are the competitive implications of continuing to operate under a regulatory capital framework that is not risk sensitive? If regulatory minimum capital requirements declined under the advanced approaches, would the dollar amount of capital these banking organizations hold also be expected to decline? To the extent that advanced approach institutions have lower capital charges on certain assets, how probable and significant are concerns that those institutions would realize competitive benefits in terms of pricing credit, enhanced returns on equity, and potentially higher risk-based capital ratios? To what extent do similar effects already exist under the current general risk-based capital rules (e.g., through securitization or other techniques that lower relative capital charges on particular assets for only some institutions)? If they do exist now, what is the evidence of competitive harm? Apart from the approaches described in this ANPR, are there other regulatory capital approaches that are capable of ameliorating competitive concerns while at the same time achieving the goal of better matching regulatory capital to economic risks? Are there specific modifications to the proposed approaches or to the general risk-based capital rules that the Agencies should consider?	*While certain to increase regulatory expenses, a bifurcated approach at the outset seems necessary especially given the enormous complexity of the advanced approaches in Pillar I. The costs of Basel II and the competitive disadvantages will increase industry consolidation. If indeed the rating agencies and the regulators wish to see all institutions adopt advanced approaches over time, the cost of such adoption would compel industry consolidation among the community, mid sized regional banks and specialized institutions. Furthermore, specialized institutions would be compelled for competitive reasons to opt-in, as customers in the market are likely to expect providers to have the advanced risk management systems.* *The intent of Basel II is not to see capital levels decline and it is clear that regulators and rating agencies do not want to see decreases. Given this narrow band of acceptable capital levels, the costs seem to outweigh the benefits. Additionally there are less costly ways to improve capital allocation from Basel I which should be reconsidered.* *It is highly probable, if not certain, that advanced approach institutions would realize those competitive benefits outlined in the ANPR question. It is the increased range of alternatives to adjust pricing, enhance ROE, and perhaps higher capital ratios that give the competitive advantage under the new Accord. Basel II can have the effect of turbo charging the competitive advantages already held by the very large international financial institutions.* *Yes, increase flexibility by permitting specialized institutions that proactively adopt the AMA for Operating Risk, but that do not have either the size, scope, or risk of a proportionately large credit exposure (as measured against capital), the ability to adopt a modified approach to credit that matches the appropriate level of sophisticated quantitative analysis to the size and risk in their portfolios. One modification would be to require all institutions to adopt the Standardized approach for credit risk and phase in more advanced concepts over time or at a late date. Another modification would permit a materiality threshold for assets including loans, securitization tranches, etc. in conjunction with the ability to use IRB or Standardized approaches.*