Written Testimony of
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Mr. Chairman and Members of the Subcommittee, thank you for inviting me to testify today on issues related to the proposed New Basel Capital Accord. This is an important issue for U.S. banking companies, including State Street, and I appreciate your interest.

I am Chairman and CEO of State Street Corporation, a global financial services company headquartered in Boston, Massachusetts. State Street provides services such as custody, fund accounting, and investment management to public and private investment institutions. Because we specialize in serving institutional investors, we have no traditional retail or credit-oriented banking services --- rather, State Street is part of the infrastructure of the global financial services industry.

As described in detail in this testimony, we believe the Basel Committee's proposal to add a new regulatory capital requirement for operational risk is misguided, and creates competitive disadvantage for U.S. banks. If provided the option, we would not choose to "opt-in" to the proposed new operational risk capital regime. However, based on our significant position in our industry sector, and the international nature of our business, we expect to be required by U.S. regulators to comply with Basel II.

Before describing our objections to the Basel proposal, however, I want make it very clear that:

- We agree with the Basel Committee that operational risk is a critical issue;
- We view the U.S. bank supervisory system as one of the best in the world, which is an asset for U.S. banks. The strength of U.S. supervision, however, also creates challenges as we compete with institutions subject to less intensive regulatory supervision abroad; and
- We believe the U.S. regulators' current efforts to address operational risk through their supervisory authority is working – and provides a strong foundation upon which to build even better risk management practices.

I will describe the Basel Committee's proposed approach to operational risk in more detail below, but, in simple terms, the proposal would create a new regulatory capital requirement for banks, based on some statistical measure of operational risk. Using the Basel Committee's terminology, operational risk would fall under "Pillar 1," which establishes capital standards, vs. under "Pillar 2," which addresses risk through regulatory supervision. Under the Basel Committee's definition, operational risk is a very broad category, including nearly all risks inherent to conducting a business, with the exception of strategic, business, or reputational risk.

We have serious concerns with the Basel Committee's current proposal to add new regulatory capital requirements for operational risk, and my testimony addresses the following major points:

- Operational risk is a real concern, but should be addressed through supervision and incentives to build operational risk controls, not additional regulatory capital;
- There is a broad consensus that quantification methodologies related to operational risk are underdeveloped and untested;
- Even with the Basel Committee's movement towards the "advanced measurement approach," the operational risk capital proposal remains problematic;
- Focusing regulatory efforts related to operational risk on regulatory capital vs. supervision creates perverse incentives which can undermine effective risk management;
- The Basel Committee's operational risk capital proposal creates significant domestic and international competitive concerns for U.S. banks, creating an unnecessary "tax" on holding a U.S. banking license; and
- U.S regulators have -- and other national regulators should have -- sufficient supervisory tools to address operational risk.

As a result, we believe U.S. regulators should insist that the Basel Committee abandon its current proposed Pillar 1 regulatory capital regime for operational risk and adopt in its place a rigorous, effective Pillar 2 supervisory treatment for operational risk.

Operational Risk: A Real Concern That Warrants Increased Supervisory Attention

Although State Street and many other U.S. banks are strongly opposed to a new requirement for additional regulatory capital related to operational risk, we agree that operational risk is a major issue that warrants supervisory and management attention. We believe an increase in such supervision can, and should, be implemented quickly --- far more quickly than is possible should regulators continue to focus limited regulatory resources on the complex and ultimately misguided current Basel operational risk capital proposal.

As defined by the Basel Committee, operational risk is the risk of loss related to system or human failures, as well as those resulting from natural or man-made disasters. Operational risk is the natural concomitant of everyday life for a financial services firm, and it is experienced by all companies in the same line of business regardless of the legal charter under which they may operate.

It is important to note that operational risk is quite different from credit risk (that is, the risk that a borrower may not repay a loan). Banks and other lenders can choose to take on more credit risk to increase profit – as is done in subprime lending, for example – recognizing that increased loan losses will be offset by the increased return on higher-risk loans. There is no such "profit-motive" for taking on additional operational risk.

The operational risk-based capital proposal appears to have been drafted with a conventional model of risk in mind, where capital serves to absorb unexpected losses and thus to protect deposit insurance funds and/or central banks. As demonstrated by the tragic events of 9/11, however, managing operational risk requires a different approach.

The events of 9/11 make it clear that operational risk mitigation activities (systems redundancy, contingency planning, disaster recovery, insurance, etc.) are essential and effective mitigants to even the most extreme forms of operational risk. Institutions that invested in operational risk mitigation absorbed the unprecedented shock resulting from the terrorist events with remarkable resiliency. Instead of actively supporting such investments, the Basel Committee's operational risk capital proposal would create a regulatory incentive to divert resources away from such investments, and towards meeting regulatory capital requirements.

It is difficult to see how a regulatory operational risk-based capital rule would have promoted the financial system's rapid recovery on 9/11. Capital would have taken time to access, and systems rebuilding would have taken still more time, delaying the resumption of market activity, and creating significant systemic risk. In contrast, redundant systems in place on 9/11 were quickly able to mitigate the effects of the terrorist attacks.

The differences between credit risk and operational risk argue for a different regulatory approach than is taken in the current Basel draft. Credit risk can be addressed with a quantitative, empirically-based regulatory capital requirement (the "Pillar 1" section of Basel), but operational risk should be addressed solely through effective and enforceable supervision under Pillar 2.

In contrast to its proposal for operational risk, the Basel Committee has decided to continue to address interest rate risk under Pillar 2. While there may be sound reasons to leave interest rate risk under Pillar 2, it is unclear why the Committee does not provide similar Pillar 2 treatment of operational risk. Unlike operational risk, there are accepted definitions of interest rate risk, and measurement of interest rate risk is a well-developed management practice. Interest rate risk is priced every day in the market, where billions of dollars of related derivatives are bought and sold. Like credit risk, interest rate risk is taken on for profit --- and, like credit risk, interest rate risk is a known and proven cause of bank failures. Interest rate risk was the predicate cause of the savings-and-loan debacle that cost this nation's taxpayers more than $250 billion in the 1980s.

Still, the Basel Committee's proposal leaves the known, measurable interest rate risk in Pillar 2, even as operational risk – far less well defined and generally not assumed for profit – is being pushed into Pillar 1.

Problems with Regulatory Capital for Operational Risk Are Well Recognized

State Street is not the only bank with deep concerns about the Basel Committee's operational risk proposal, nor are banks the only ones opposed to the proposed Basel Pillar 1 approach. Since the Basel Committee released the first version of its operational risk proposal in 2001, many banks have commented on the need to consider operational risk as part of Pillar 2, and operational risk remains one of the most controversial elements of the Basel Committee's proposed New Capital Accord.

These concerns are echoed by a number of recent statements, including one from the Basel Committee's sister panel, the Committee on the Global Financial System, which is chaired by Federal Reserve Board Vice Chairman Roger Ferguson. In a January, 2003 assessment of the prospects for credit risk transfer, the Global Financial System Committee found:

> "[Operational and liquidity risk] are more difficult to measure than credit and market risk, and it may be difficult to deal with them in quantitative capital rules and disclosure standards. A more qualitative approach, focusing on risk management, may be needed."

The Financial Services Authority in the United Kingdom has also voiced concerns in its own supervisory approach to operational risk. Although a signatory to Basel, the FSA noted in its own pending standards for operational risk:

> "… due to both data limitations and a lack of high powered analysis tools, a number of operational risks cannot be measured accurately in a quantitative manner at the current time."

Speaking about implementation of the operational risk-Based capital requirement in the European Union, a major policy-maker from the FSA has indicated that the EU's Capital Adequacy Directive may take a different – and more lenient – approach to operational risk-based capital than Basel.

Finally, U.S. regulators remain at odds about the value of a Pillar 1 approach to operational risk. In its formal comments to Basel in 2001, the Federal Reserve Bank of Chicago rightly noted:

> "In part [the operational risk requirement] appears to be due to concerns not about operational risk per se but that making market and credit risk more risk sensitive will permit some banks to hold too little capital…We are concerned…that basing capital charges for operational risk capital on business activity provides little incentive to manage these risks."

On June 6, 2002, in remarks to the Risk Management Association, Comptroller of the Currency Hawke said:

> "A one-size-fits-all approach to operational risk — such as a formulaic capital charge based on some percentage of gross revenues or a percentage of the charge for credit risk — while simple to apply, would disadvantage the best managed banks and provide undeserved advantage to the worst managed. Worst of all, it would provide no incentive to improve internal control systems…I've repeatedly argued that operational risk is a subject peculiarly appropriate for assessment under the Pillar 2 approach -- an approach that relies on supervisory analysis rather than numeric formulas."

Current Pillar 1 Approach Remains Problematic

The most recent version of the Basel operational risk-based capital proposal includes three options:

- a "basic-indicator" capital requirement based on a percentage of a bank's overall gross income;
- a "standardized" requirement assessed on gross income on a line-of business basis; and
- an "advanced measurement approach," or AMA, which relies on internal risk models.

Each of these options has grave conceptual and methodological flaws.

The "basic-indicator" and "standardized" approaches' reliance on gross income (which we read to approximate total revenue) is simply misguided. There is no empirical data that suggests that operational risk bears a linear relationship to gross income, and our experience at State Street suggests that the two factors are not related. Without such data, reliance on gross income as a capital driver is contrary to the Basel Committee's goal of making the capital regime more risk-sensitive.

A gross income-based operational risk-based capital rule is analogous to the old leverage capital standards, which the first Basel Accord eliminated. Gross income is no more an indicator of real operational risk than gross on-balance sheet assets were of credit risk. Measurement of operational risk along these lines is a backward step in the Committee's overall capital methodology.

In addition, the use of gross income as a risk indicator creates a strong incentive for banks to reduce their investments in operational risk mitigation. Under the "basic-indicator" and "standardized" approaches, banks will bear the same capital requirement regardless of the very significant differences in net income that result when banks make prudent investments in costly insurance, back-up systems, distributed processing, and the other forms of operational risk mitigation. Further, gross income does not reflect the prudent reserves that institutions operating under a robust Pillar 2 framework should establish for defined operational risks.

Reliance on gross income, in essence, fails to reward (through lower capital requirements) banks that choose to lower net income through significant investment in operational risk management and mitigation.

The "standardized" approach, which assesses capital based on gross income on a business line basis, suffers from additional flaws. The Basel Committee's delineation of business lines conflicts with those adopted by many banks for strategic reasons, creating additional complexity and implementation issues.

Reflecting the many measurement and policy issues in the original Basel Committee approach to operational risk-based capital, the latest information from Basel indicates that the next version of the Basel proposal will contain significant revisions to the initial one issued in January 2001.

The Basel Committee, at the urging of U.S. regulators, is now proposing that banks have the option to assess capital based on an "advanced measurement approach" (AMA), under which internal models would play a major role in determining regulatory capital. Recently, U.S. regulators have indicated that they are now considering requiring that all U.S. banks subject to the operational risk-based capital proposal use the AMA approach.

Unfortunately, while an improvement over the 2001 Basel Committee proposal, the AMA is equally unworkable, and raises many of the same conceptual and policy-related issues raised by the more basic operational risk quantification methodologies.

To the extent that the AMA relies on a bank's internal models and loss data, it is an improvement over the Basel Committee's far cruder assumption that operational risk is linearly related to gross income. However, while some of the concepts underlying the AMA may be useful in evaluating capital adequacy under Pillar 2, they are far too underdeveloped and untested to form the basis for a regulatory capital requirement under Pillar 1.

There are considerable technical challenges to implementing a Pillar 1 capital requirement using AMA. For example, the AMA requires the use by banks of outside data as a supplement to internal data. Useful outside data is sparsely available, and often inconsistent. Integrating such external data into an AMA model in a useful manner will be very difficult, requiring scaling for a wide variety of factors related to product lines, control environment, and the scale of activity. Well managed institutions will face special challenges, as their lack of loss data due to sound management practices will result in requirements to seek out and import irrelevant loss data from other, less well run, institutions. As with many other aspects of operational risk quantification and measurement, the integration of such data is highly experimental and unproven. As a result, any capital requirement based on the AMA will be equally suspect, and creates a high risk of severe -- but misguided – regulatory penalties for failure to meet Pillar 1 regulatory capital thresholds.

While the technical challenges related to AMA are daunting, the more significant flaws to the Basel Committee's Pillar 1 proposal are more conceptual. The primary substantive argument for including operational risk as part of Pillar 1 appears to be a desire for even and transparent application of operational risk regulation between institutions, and across jurisdictions. The very nature of the AMA, however, will result in just the opposite outcome.

The AMA is highly complex, and depends on a wide variety of highly subjective assumptions. Imposing a capital requirement based on the AMA will require tremendous amounts of supervisory guidance and scrutiny. Even then, ensuring consistency between banks and jurisdictions will be nearly impossible. The very subjective nature of the AMA, combined with the very nascent state of operational risk quantification methodology, invites "gaming" between jurisdictions --- an outcome we assume the Basel Committee is attempting to avoid.

The subjective and experimental nature of the AMA requires adoption of a more flexible approach than that dictated by a Pillar 1 regulatory capital measurement. Capital adequacy related to operational risk is important, but can be far more suitably addressed through a Pillar 2 supervisory approach.

In sum, each of the options offered by the Basel Committee for calculating additional regulatory capital for operational risk is deeply flawed.

Potential Perverse Regulatory Incentives Undermine Effective Risk Management

An explicit addition to regulatory capital for operational risk that fails to take account of risk mitigation would create a perverse incentive for banks to shed insurance, eliminate reserves and reduce expenditures dedicated to operational risk mitigation. As noted, the difficult and tragic experience of the financial services industry in the wake of the World Trade Center attacks makes it clear that incentive-compatible regulation should emphasize, not run counter to, effective operational risk mitigation. Quite simply, no amount of operational risk-based capital would have been enough to bring the U.S. financial system back on-line as quickly as occurred after the September 11 attack.

Less cataclysmic instances of operational risk also point to the critical importance of effective risk mitigation, and the fact that an operational risk-based capital requirement would have little impact on either preventing or correcting problems. The most often cited possible case of a bank failure related to operational risk is that of Barings in 1995. As is well known, the centuries-old British bank failed due to the lack of fundamental and basic operational risk management techniques. Ultimately, these losses amounted to £850 million -- far in excess of the approximately £82.5 million the bank would have added to its regulatory capital under the Basel Committee's current proposal.

Would this additional capital requirement have prevented the rogue trading? Of course not, but effective internal controls and independent reporting lines would have done so – and effective supervision would have ensured that things were in place to prevent such catastrophic losses occurring without detection by the bank or its supervisors.

Major Competitiveness Concerns

Addressing operational risk through additional regulatory capital requirements, as contemplated by the Basel Committee, would have significant domestic and international competitive impacts on U.S. banks.

First, U.S. banks compete in a number of business lines with non-banks.

For example:

- In investment management, banks compete with companies such as Fidelity and Vanguard.
- In fund accounting and financial technology, banks compete with firms such as BISYS, SunGard and SEI Investments.
- As payments processors, banks compete with First Data, NPC, and Nova Information Systems.
- Banks compete in numerous areas with non-bank financial institutions, such as broker-dealers.

These are just a few examples -- and it is precisely these business lines where the Basel operational risk proposal will have the most detrimental effect.

In the U.S., only banks are subject to the current bank capital rules, and only banks will be subject to the new capital requirement for operational risk. Although the European Union hopes to impose the Basel capital regime on many non-banks, it is not possible for U.S. regulators to do, due to both statutory restrictions and the strong opposition of non-banks to the possibility of being forced under the Basel capital rules.

The result under the Basel proposal is an uneven playing field -- creating an unnecessary "tax" on banking licenses, and a competitive disadvantage for banks.

Second, the Basel Committee's operational risk proposal will hurt U.S. banks in the international marketplace. U.S. banks dominate the global market for services such as custody and investment management. The rigorous supervision of banks by U.S. regulators is an important element in this success.

The Basel Committee's proposed treatment of operational risk, however, does not play to the strengths of the U.S. regulatory system. Instead, the proposal is a "lowest common denominator" approach, reflecting the inability of many overseas regulators to supervise and examine banks rigorously. As a result, the proposal attempts to quantify operational risk with questionable statistical models, instead of more appropriately focusing on risk management processes and procedures.

The result is a proposed regime, where, for example, capital requirements for legal risk will place a greater burden on U.S. banks than their overseas competitors. In addition, certain laudable features of the U.S. regulatory system that have not been adopted in other jurisdictions -- such as the "prompt corrective action" regulations and frequent on-site examinations -- create very serious repercussions for U.S. banks that fail to meet regulatory capital ratio thresholds which are well above the minimum ratio requirements. As a result, U.S. banks will face far more serious regulatory consequences from errors introduced into regulatory capital calculations by admittedly imprecise operational risk capital assessments.

Finally, U.S. banks simply have no confidence that the Basel rules will be applied evenly in all jurisdictions.

The experience with Japanese implementation of the 1988 Capital Accord is instructive. Japanese regulators exploited numerous loopholes of the 1988 Accord -- and then simply did not require banks to write off bad loans. The result was nominal -- but fictional -- compliance with the Accord.

Similarly uneven application of a new operational risk requirement will have serious competitive impacts for U.S. banks.

Imposing new capital requirements for operational risk may create unintended pressure for U.S. banks to consider conducting business under other, non-bank forms of organization. Should major U.S. providers of investment management and similar services abandon their banking charters, systemic risk would likely increase. Appropriate supervision of operational risk would create a far sounder systemic framework without introducing new incentives for institutions to operate outside the bank regulatory system.

U.S. Regulators Have – and Others Should Have – Supervisory Tools to Address Operational Risk

As noted, State Street believes that operational risk is a major issue that can be far better addressed through effective supervision (Pillar 2) than an unproven, inappropriate, and technically flawed Pillar 1 regulatory capital requirement. We strongly support the most recent Basel "Sound Practices Paper" proposal for operational risk and urge quick action on it.

One of the arguments U.S. regulators have used in defense of the Basel Pillar 1 approach is that they lack the tools to ensure effective operational risk management. As a U.S. bank, operating under the supervision of U.S. regulators, we disagree. Bank regulators have been provided wide powers and discretion by Congress, and can impose sanctions for any practice that does not meet standards for safety and soundness. Congress recently gave U.S. bank regulators even more power to ensure effective risk mitigation. The Gramm-Leach-Bliley Act allows only financial holding companies that meet the standards for being both "well managed" and "well capitalized" to retain financial holding company status. Recently, the Federal Reserve and OCC denied this status to a large regional bank due to a combination of problems, including failures to manage certain operational risks. The bank moved quickly to correct these problems, as have others fearing similar sanctions.

In many cases, regulators in other nations lack the strong supervisory resources enjoyed by U.S. regulators. It is sometimes argued that a Pillar 1 approach is necessary to ensure improved operational risk management in these nations. The lack of supervisory resources in other nations, is, however, not sufficient to justify the negative impacts of a Pillar 1 operational risk approach. Supervisors around the world should instead be encouraged to develop the supervisory ability to implement a strong Pillar 2 approach to operational risk -- an ability already present with U.S. regulators.

Finally, some have argued that the simple threat of the operational risk-based capital requirement has led banks to improve operational risk measurement and management. As noted above, however, U.S. regulators already have ample resources to push U.S. banks to improve operational risk management, and foreign regulators can and should focus on operational risk management, not simply levels of regulatory capital.

Conclusion

We urge Congress to carefully consider that:

- Despite the adoption of the potentially improved Advanced Measurement Approach to calculating operational risk-based capital, the Basel Committee's operational risk capital proposal remains unworkable;
- The operational risk capital proposal creates a perverse incentive against banks' investment in systems, processes, and people to avoid operational losses;
- The Basel Committee's operational risk capital proposal creates unnecessary competitive disadvantage for U.S. banks competing with non-banks, and with non-U.S. competitors;
- U.S. regulators have sufficient supervisory authority to require strong operational risk management practices, including the evaluation of capital adequacy – and other national regulators should be given similar authority; and
- Operational risk would be far better addressed through a Pillar 2 supervisory approach.

We urge Congress, and the U.S. banking regulators, to consider the negative impact of the Basel Committee's operational risk capital proposal on U.S. banks, and to work towards a more suitable Pillar 2 supervisory regime for operational risk management regulation.