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Secretariat of the Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel
Switzerland

Consultative Document – Strengthening the Resilience of the Banking Sector

Dear Sir/Madam:

State Street Corporation ("State Street") welcomes the opportunity to comment on the Consultative Document issued by the Basel Committee on Banking Supervision ("Basel Committee") regarding measures to strengthen the resilience of the banking sector.

Headquartered in Boston, Massachusetts, State Street specializes in providing institutional investors with investment servicing, investment management and investment research and trading. Our client base represents a broad range of traditional long-term investors such as mutual funds and other registered collective investment vehicles, corporate and public retirement plans, insurance companies, foundations and endowments. With $18.8 trillion in assets under custody and administration, as well as $1.9 trillion in assets under management, we operate in 25 countries and more than 100 markets worldwide.[1]

In the wake of the global financial crisis, the Basel Committee proposes a number of measures to improve the banking sector's ability to withstand financial shock, thereby also reducing the potential propagation of risk to the underlying economy. More specifically, the Basel Committee proposes broad changes to the existing definition of regulatory capital, enhancements to the coverage of the Basel risk-based framework and the introduction of a supplementary leverage ratio. In addition, the Basel Committee presents its initial views on steps to enhance Pillar III disclosures, reduce the banking

[1] As of December 31, 2009.

industry’s sensitivity to downward pro-cyclical pressure, promote the development of capital buffers that can be used to mitigate losses during periods of stress, and measures to address both systemic risk and risk associated with the interconnection of global financial institutions.

State Street appreciates the Basel Committee’s efforts to draw lessons from the financial crisis and improve the stability of the global banking system. This includes the development of a more consistent and transparent regulatory capital framework. We note, however, the importance of agreeing on an approach which does not unnecessarily disrupt global financial markets, including the banking industry’s ability to conduct its essential credit intermediation function. It is also important to develop a framework which is proportionate and which reflects the considerable progress which the banking industry has made, including via the Basel II framework, to both identify and effectively mitigate risk.

Unfortunately, as currently drafted the Basel Committee’s proposal contains a number of measures which are likely to result in an overly restrictive assessment of bank regulatory capital. More specifically, State Street is concerned about the proposed treatment of trust preferred securities (“TPS”), unrealized mark to market losses on available for sale (“AFS”) investment securities, deferred tax assets (“DTA”) and exposure to certain securitized assets, specifically those with long-term ratings more than one category below investment grade.

In addition, we are concerned that the proposed leverage ratio is unnecessarily rigid and that it has the potential to act as a de facto, non-risk sensitive capital constraint on essential financial activity. This includes the proposed disallowance of netting and the highly conservative treatment of certain off-balance sheet items, such as committed but undrawn lines of funding. This also includes the potential treatment of certain well-established, low-risk financial activities, such as securities financing undertaken on an agency basis.

As a general matter, we note that the Basel Committee’s approach incorporates two frequently divergent views of capital. The first reflects capital on a “going” concern basis, and includes among other measures, the recommendation that banks hold substantially greater amounts of common equity. This contrasts, however, with the envisioned treatment of DTA’s, which are required to be deducted in full from Tier 1 capital, in spite of their substantial value in re-building “going” concern capital after a period of stress. The second reflects capital on a “gone” concern basis, such as the recommended deduction of unrealized mark to market losses from Tier 1 capital. This contrasts in turn, with the proposed elimination of TPS from capital, notwithstanding the important protection which subordinated debt instruments provide to depositors and other debt holders in the event of liquidation. In effect then, the proposed framework is generally predicated on the worst of the two views of capital, an approach which we view as unduly conservative.

State Street therefore recommends a number of enhancements to the Basel Committee's proposed framework, designed to both improve the economic assessment of risk and mitigate highly significant capital volatility.

Trust Preferred Securities

In its proposal, the Basel Committee recommends the elimination of TPS from the definition of Tier 1 capital. TPS are a common and widely accepted form of subordinated debt, with important loss absorption capabilities on both a "going" and a "gone" concern basis. As such, we believe that their wholesale elimination from Tier 1 capital would be extreme, and if not carefully implemented, could disrupt the banking industry's ability to raise operating capital, particularly during periods of financial market stress.

We therefore urge the Basel Committee to consider in its intended definition of Tier 1 capital, the permanent grand-fathering of existing TPS. Alternatively, we recommend that the Basel Committee agree to a lengthy phase-out process, designed to both mitigate market disruption and enable the development of suitable, cost effective alternatives. In our view, an appropriate transitional period for the elimination of TPS from Tier 1 capital would be on the order of 10 years.

Unrealized Losses on AFS Investment Securities

As currently drafted, the Basel Committee's proposal would require the full deduction from Tier 1 capital of mark to market losses on investment securities held by a banking institution as available for sale. In our view, this represents an unnecessarily rigid approach which greatly overstates potential credit risk, while simultaneously increasing capital volatility.

By their very nature, unrealized losses are temporary and largely reflect pricing and liquidity constraints as well as interest rate movements, rather than underlying credit risk. As such, mark to market losses do not represent an accurate economic assessment of the performance of an asset over time and are not consistent with a "going" concern view of capital. This is supported by a number of measures, including the substantial gap which exists between observed historical mark to market losses and actual other than temporary impairment ("OTTI"), including at the height of the financial crisis. This is also reflected in the results of OTTI stress testing, such as the Federal Reserve's Supervisory Capital Assessment Program ("SCAP"), which did not reveal levels of economic impairment on investment securities anywhere near assumptions predicated on mark to market calculations.

State Street therefore recommends that the required deduction of unrealized losses from Tier 1 capital be limited to losses determined via supervisory approved internal cash flow models at an appropriate degree of stress. In addition to improving overall risk sensitivity and reducing unnecessary capital volatility, this has the advantage of

providing banks with an incentive to further develop their risk modeling and risk management expertise. Moreover, any concerns regarding modeling risk can be addressed via a series of appropriately structured haircuts, as well as normal course Pillar II regulatory assessments.

Deferred Tax Assets

The Basel Committee's proposal would require DTA's dependant on taxable income to be deducted in full from Tier 1 capital. While we appreciate concerns regarding the ability to make use of DTA's in the event of a probable insolvency, we believe that these assets should generally be assessed on the basis of a banking institution as a "going" concern. Viewed from this perspective, DTA's offer banking institutions with an important source of strength when rebuilding capital after periods of stress.

DTA's attributable to temporary losses, such as those associated with the required consolidation of off-balance sheet commitments under Financial Accounting Standard 157, are recovered as market conditions improve. As such, they are not dependant upon the generation of future taxable income. Similarly, DTA's which arise from realized losses often have lengthy carry forward periods of 20 years or more, thereby providing crucial flexibility to monetize the asset after the period of stress has passed.

State Street therefore recommends that DTA's continue to be included within the definition of Tier 1 capital, subject to certain limitations broadly consistent with existing accounting standards and regulatory requirements. Specifically, DTA's should only be deducted from Tier 1 capital to the extent there is a DTA balance after taking into account the following adjustments:

- Reduction for deferred tax liabilities;
- Adjustment to reflect deferred tax balances attributable to unrealized losses;
- Reduction for the portion used to offset earnings in the statutory loss carry-back period;
- Reduction for the portion that can be utilized to offset earnings in the current and immediately subsequent year.

Thus, the deduction of DTA from Tier 1 capital would be limited to the excess of the net DTA balance, as adjusted for unrealized losses, carry back losses and offsets to income for the current and subsequent year. In addition, concerns regarding the magnitude of the DTA compared to overall equity could be addressed by incorporating a further limitation based on a percentage of capital (*e.g.* net DTA no greater than 10% of equity), such as exists today under US regulatory standards.

Securitized Assets

In its proposal, the Basel Committee recommends that certain exposures, including those to securitized assets with long-term ratings more than one category below investment grade, receive a risk weighed charge of 1250%. This represents an incremental change from the existing Basel II framework, where such exposures would be deducted from regulatory capital (50% from Tier 1 and 50% from Tier 2). In either case, however, the Basel Committee's approach is predicated on the use of external credit ratings to determine regulatory capital. In our view, this approach is outdated and can result in a highly inaccurate assessment of underlying economic risk.

Numerous developments since the publication of the Basel II framework have revealed significant weaknesses in the use of external credit ratings for the calculation of exposure to securitized assets. First, the performance of the rating agencies with respect to securitized assets is now widely understood to have been inadequate and there is no longer a strong market-wide acceptance of their work.

Second, the structural assumptions underlying the treatment of securitized assets within the Basel II framework are no longer accurate. In particular, assumptions regarding down-graded investment assets greatly overstate their economic risk to the banking industry. This includes an over-emphasis on default risk rather than the more appropriate assessment of the underlying severity of default, as it relates to specific tranches within applicable waterfall structures. Third, the delegation of regulatory authority to rating agencies for the calculation of such exposures is no longer necessary and contradicts the long-standing Basel tenet regarding the value of internal risk-based measurements.

Several important options have developed since the publication of the Basel II framework which provide highly effective alternatives to the continued use of external credit ratings. As an example, the recent Federal Reserve SCAP exercise projected anticipated bank losses on securitized assets based upon loss rates for comparable non-securitized loan portfolios weighted against relevant levels of credit support. Similarly, the US National Association of Insurance Commissioners has implemented a modeling process for the calculation of capital on residential mortgage-backed securities that eliminates the use of external credit ratings in favor of assessments derived from third party modelers.

As a result, State Street strongly recommends that the treatment of securitized assets for capital purposes be based on cash flow estimates derived from properly supervised, institution specific modeling. This can be achieved by replacing the existing default-based ratings in the Basel II lookup table with a cash flow derived assessment of expected loss. This could in turn be determined by reference to either internal or external data inputs, with the former having the advantage of making the treatment of securitized assets under the Basel II framework consistent with the existing Internal Ratings Based approach for non-securitized assets.

Leverage Ratio

The Basel Committee proposes the introduction of a new and uniform global leverage ratio. It is designed to supplement the Basel II risk-based framework, and incorporates a "no netting" provision, as well as the requirement to account for all off-balance sheet exposures at 100% of notional value. As such, it differs rather markedly from the leverage ratio currently in place in the US.

Although we recognize that a leverage ratio can assist supervisors in monitoring general levels of risk, we do not believe that it should be used to supplant the more risk sensitive assessment of capital under the core Basel II framework. In addition, we are concerned that the proposed approach is overly onerous and does not reflect the observed experience of the banking industry during periods of market stress, including the recent financial crisis.

As an example, we do not believe that it is reasonable to exclude all netting arrangements from the calculation of an institution's leverage exposure. This would ignore the broad acceptance of netting as a legally-tested mechanism for the mitigation of risk, including in respect of derivatives and securities financing transactions. Indeed, by disallowing its use, the Basel Committee risks expanding the size of a bank's balance sheet in a highly misleading and risk insensitive manner, with broadly negative implications for certain routine yet essential lines of business, such as securities financing.

Similarly, the need to assume the full drawn-down of all off-balance sheet exposures, such as committed lines of funding, is likely to vastly overstate the actual risk faced by a banking institution, while discounting observable experience during instances of market stress. As an example, even at the peak of the financial crisis, State Street's exposure to certain committed lines of funding, such as redemption lines for our mutual fund clients, never exceeded 10% of availability. This is far less than the proposed approach, which would require the assumption of a 100% drawn down.

State Street therefore recommends that the Basel Committee's proposed leverage ratio only be used as a component of the Pillar II regulatory review process, rather than as a means of adjusting Pillar I requirements. As part of regulatory discussions on the modeling of capital, it has been communicated to us that capital "add-ons" are not intended to address Pillar I core capital assessments. We agree with this view and believe that it should also prevail in the context of the proposed leverage ratio.

Similarly, we believe that the leverage ratio should be revised to ensure greater accuracy and proportionality. This includes the full incorporation of legally enforceable netting, as well as the treatment of off-balance sheet exposures on the basis of relevant and observable institution-specific modeling and market experience. Finally, we urge the Basel Committee to carefully consider the appropriate basis for measuring certain well-established, low risk financial activities, such as securities financing undertaken on an agency basis, where notional and effective risk can significantly diverge.

Thank you once again for the opportunity to comment on the critical matters raised within this Consultative Document. To summarize, State Street recommends a number of adjustments to the Basel Committee's proposed capital framework, including the grand-fathering or at least the lengthy phasing out of TPS instruments, the continued ability to account for certain unrealized losses on AFS investment securities, the preservation of DTA's in accordance with existing accounting standards and regulatory requirements, and the treatment of securitized assets for capital purposes based on internally derived cash flow estimates. In addition, we recommend the introduction of greater proportionality in the envisioned leverage ratio, and that it is only be used as part of the Pillar II regulatory assessment process.

Please feel free to contact Bill Schomburg, Director of Economic Capital (whschomburg@statestreet.com) should you wish to discuss State Street's submission in greater detail.

Sincerely,

Stefan M. Gavell