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Via e-mail: baselcommittee@bis.org

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

Consultative Document – International Framework for Liquidity Risk Measurement, Standards and Monitoring

Dear Sir/Madam:

State Street Corporation ("State Street") appreciates the opportunity to comment on the Consultative Document issued by the Basel Committee on Banking Supervision ("Basel Committee") regarding the establishment of an international framework for the measurement and ongoing monitoring of liquidity risk.

Headquartered in Boston, Massachusetts, State Street specializes in providing institutional investors with investment servicing, investment management and investment research and trading. Our clients represent 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]

The Basel Committee proposes the establishment of two regulatory standards to gauge a banking institution's ability to withstand a combination of idiosyncratic and market-wide shock; a Liquidity Coverage Ratio ("LCR") to address instances of acute short-term stress over a period of 30 days and a Net Stable Funding Ratio ("NSFR") to promote the development of more resilient long-term structural funding over a one-year time horizon.

[1] As of December 31, 2009.

In addition, the Basel Committee proposes the establishment of a series of common metrics to ensure the consistent identification and monitoring of liquidity risk.

State Street welcomes the Basel Committee's efforts to draw lessons from the financial crisis and improve the framework for the management of liquidity within the global banking system. This includes its April 2008 "Principles for Sound Liquidity Risk Management and Supervision". We support the establishment of quantitative standards, such as the LCR and the NSFR for the management of liquidity risk, provided that these standards carefully reflect the business profiles of varying entities within the global banking industry.

As currently drafted, however, we believe that the Basel Committee's approach does not take into consideration the particular profile of the custodian banking industry. This includes the characteristics and behavior of its core customer deposits, as well as closely related lending facilities. In addition, the Basel Committee makes a number of assumptions regarding the liquidity characteristic of certain assets and liabilities not supported by experience during the financial crisis. This includes the envisioned narrow definition of high-quality liquid assets and the lack of provisions for scheduled amortizations and expected pay-downs on investment securities with stated maturities greater than one year. We also note the inconsistent treatment of goodwill and other intangible assets for the purposes of calculating liquidity requirements over a one-year time horizon.

As a general matter, we emphasize the importance of developing a liquidity framework which avoids both macro-economic and market dislocation, including continued industry access to a wide range of high quality securitized assets. We also note our concern regarding the potential unintended consequence of the Basel Committee's proposal.

As an example, designating mortgage backed securities ("MBS") and other similar asset backed securities ("ABS") as illiquid assets may drive up the cost of funding in both retail and wholesale markets. Similarly, severe deposit runoff assumptions during periods of stress may serve to make deposits less attractive as a source of funding, thereby leading to greater market instability, as well as increased consumer costs. In the context of the custodian banking industry, the rising cost of both capital and deposits are likely to lead to increases in servicing fees and therefore lower investment returns on essential retirement, savings and other wealth accumulation vehicles.

State Street therefore recommends that the Basel Committee consider a number of targeted adjustments to its reform proposal, designed to better align the rule's principles with the realities of the custody industry's business model, while also more appropriately addressing overall liquidity risk. Our specific recommendations are set forth below.

Custodial Deposits

The Basel Committee's proposed framework for the calculation of cash outflows during a stress event does not distinguish custodial deposits from general sources of wholesale funding and therefore assumes a punitive LCR and NSFR run-off rate of 100%. This is inconsistent with both the nature of custodial deposits and the experience of the custody industry during the financial crisis.

Custodial deposits originate primarily from assets held on behalf of collective investment funds ("CIF"), such as mutual funds and other registered investment vehicles, corporate and public retirement plans, insurance companies, endowments and foundations. CIF are characterized by routine investment-related activity and maintain a close operational relationship with their custodian banks.

First, CIF rely on their custodian banks to facilitate day-to-day investment-related activity, such as the buying and selling of securities, the execution of foreign currency transactions, the receipt and distribution of dividends and the processing of corporate actions. Second, CIF rely on their custodian banks to maintain liquidity buffers designed to cover, among others, client subscriptions and redemptions, the payment of investment fees and other expenses, differences in redemption vs. securities settlement cycles and unadvised movements of cash.

Third, CIF also depend on their custodian banks to manage their liquidity buffers, which generally represent a small proportion (typically less than 1%) of overall assets. Indeed, even larger CIF rarely manage more than their working currency accounts, since the required resources and expertise generally make it easier to rely on the custodian as a single counterparty. As a result of these core needs, it would be difficult if not impossible for CIF to cease or even substantially reduce transactional banking with their designated custodian. This is certainly the case in the short term, if not also in the medium term.

Although custodial deposits are not contractual, the underlying relationship between the custodian and the fund is governed by contract. This is unique to the custodial industry and includes specific provisions regarding the termination of the relationship and the migration of assets to another custodial entity.

Custodial contracts incorporate specific minimum notification periods, which can range anywhere from 30 days to one year. Even after notification of termination, the CIF and the custodian must develop and agree to a plan for the transfer of assets. Depending upon the scope the relationship, this can be quite complex and includes the establishment of client profiles on relevant custody and accounting systems, the migration of accounting and other financial data, the initiation of a parallel period of shadow accounting and the notification of revisions to settlement instructions for all counterparties that transact with the CIF across all relevant global markets.

Although periods of 6 to 12 months are typical, in some cases the transfer of a custodial relationship can take several years to complete. Transitional time frames are in turn likely

to be significantly longer if multiple CIF were to attempt to leave a custodian entity at the same time. Most importantly, throughout this transition period, CIF are unlikely to reduce their existing transactional balances since these are necessary to ensure both continued investment activity and overall operational stability.

Consistent with these dependencies, statistical analysis demonstrates that a substantial proportion of custodial deposits reflect the characteristics of core, stable funding. In fact, the behavior of State Street's custodial deposits has historically been more closely aligned with retail deposits than with traditional wholesale funding.

In addition, custodial deposits tend to behave rather uniquely during times of market stress. State Street's experience during the financial crisis was that customer deposits increased, at times substantially, when market fears surfaced. This occurred in spite of considerable market and idiosyncratic stress, thereby demonstrating the unique role of the custodian banking industry in the financial system, as well as the close inter-relationship between custodial deposits and CIF investment activity.

State Street therefore recommends that custodial deposits be treated under the liquidity framework in the same manner as operational deposits related to corporate, sovereign, central bank and public sector entities. This would imply an LCR run-off rate of 25%, as well as partial treatment at the insured stable funding rate of 7.5%. Consistent with the historical behavior of these deposits, this would also imply an NSFR factor of 70%.

Alternatively, banks should be permitted to use supervisory approved internal modeling to characterize the stable component of their custodial deposits. This would ensure the far more accurate and granular assessment of a banking institution's deposit profile than what is afforded by the Basel Committee's envisioned framework.

Committed Lines of Funding

The Basel Committee proposes, for the purposes of the LCR, that committed lines of funding to financial institutions be drawn down at a rate of 100%. This is in contrast to committed lines to non-financial corporates which are assumed to draw down at a rate of 10%. In State Street's view, this approach is far too inflexible and therefore presents an inaccurate assessment of the liquidity implications of funding provided to certain financial entities, such as mutual funds, other registered funds and funds managed to the same regulatory standard.

As noted in our discussion of custodial deposits, mutual funds and other similar entities have an ongoing operational relationship with their custodian banks. This includes committed lines of funding provided to facilitate certain routine matters, such as client redemptions. Consistent with their limited intent, these lines of funding represent only a small proportion of a fund's assets and contain short contractual repayment obligations, generally between 30 and 60 days. In addition, custodial banks are generally protected

from extended credit risk by the contractual ability to sell off assets held by the fund to clear outstanding obligations.

Moreover, an assessment of historical data reveals utilization rates on redemption lines for mutual funds and other similar entities well below the 10% threshold envisioned for non-financial corporates. This is true even during times of stress, such as the recent financial market crisis.

State Street therefore recommends that the Basel Committee amend its proposed liquidity framework so that committed lines of funding provided to mutual funds, other registered funds and funds managed to the same regulatory standard, are treated in the same manner as lines of funding provided to non-financial corporates. This would imply an LCR draw down rate of 10%.

In addition, State Street recommends that the Basel Committee consider the introduction of more granularity in the treatment of other committed lines of funding, such as those provided to insurance companies and municipal finance. This is designed to address the anomaly of a framework with only two drawn down assumptions (10% and 100%), as well as observed historical rates of utilization. In our view, this can best be accomplished by permitting the use for draw down assumptions on certain specific committed lines of funding, of the results of supervisory-approved internal modeling.

Definition of High-Quality Liquid Assets

State Street agrees with the Basel Committee's description of the fundamental characteristics of high-quality liquid assets, namely low credit and market risk, ease and certainty of valuation, low risk correlation with other assets and broad availability via established market trading mechanisms. We also believe that this approach should be consistently applied across all relevant marketable debt securities. We emphasize, in this respect, the importance of ensuring the existence of a sufficiently diverse pool of high quality liquid assets, particularly during periods of acute stress.

State Street therefore supports the suggested incorporation of both corporate and covered bonds within the intended definition of high-quality liquid assets. In addition, we note the well-established role of agency sponsored MBS in the provision of funding to the banking industry, particularly in the U.S. This includes its status as an important component of eligible central bank collateral. Indeed, even at the height of the financial crisis, agency sponsored MBS displayed strong evidence of structural liquidity, including the existence of deep and active repurchase markets.

As a result, we strongly recommend that the Basel Committee also consider the inclusion, within the intended definition of high-quality liquid assets, of agency sponsored MBS. Consistent with the envisioned treatment of covered and corporate bonds, any residual concerns regarding the liquidity profile of these instruments can best

be addressed via a properly calibrated system of haircuts, rather than via their outright exclusion from the proposed framework.

Finally, State Street also recommends the possible inclusion within the definition of high quality liquid assets of other highly-rated ABS with credit and market risk profiles similar to those of corporate and covered bonds. While the liquidity of these securities was impacted during the financial crisis by the need to trade "good" securities in the same illiquid market as poor securities, highly-rated ABS remain an important and stable source of bank liquidity. We note in this respect that highly-rated ABS are eligible as central bank collateral and that the markets for these securities have substantially improved. Given their particular profile, however, we believe that a conservative haircut of 40% applied to AAA rated ABS would be appropriate.

Pre-payments on MBS/ABS

Under the proposed liquidity framework, banking institutions are not provided with credit for scheduled amortizations and expected pre-payments on investment securities, unless the security matures within a one-year time horizon. As a result, banks are required to support these routine and readily quantifiable inflows of cash with long-term funding. This contrasts rather dramatically with the treatment of investment securities that mature within the one-year horizon, where a full liquidity credit is recognized.

In State Street's view, this is an unnecessarily stringent approach which fails to take into consideration industry experience, while also creating an undesirable "cliff effect" in respect of the liquidity value of assets held. We note in this regard that many pooled investment securities, such as agency sponsored MBS, are structured as long-term investment vehicles, and therefore have official maturity dates which may extend out for decades and which do not correlate with the performance of the underlying assets.

Also, even at the height of the financial crisis, investment securities continued to provide the banking industry with meaningful sources of liquidity regardless of the underlying term to maturity. Further, we note that as part of normal liquidity management practices, banking institutions already account for the performance of pooled securities held in the investment portfolio.

As a result, we strongly recommend that the Basel Committee incorporate within its liquidity framework scheduled amortizations and expected pre-payments on investment securities, regardless of term to maturity, as derived from supervisory approved internal modeling. Consistent with the overall Basel framework, concerns regarding potential modeling risk should be addressed via an appropriately calibrated system of haircuts, such as proposed for covered and corporate bonds. In our view, this would ensure the better calibration of the intended framework, without undermining its core operative principles.

Intangible Assets

In its consultation on Strengthening the Resilience of the Banking Sector, the Basel Committee proposes that goodwill and other intangible assets should be deducted in full from the common equity component of Tier 1 capital. From a liquidity perspective, this is accounted for by incorporating regulatory capital within the definition of the NSFR numerator, or what is referred to as Available Stable Funding (“ASF”). However, by also including goodwill and other intangible assets within the NSFR denominator (i.e. the Required Stable Funding), the Basel Committee is in effect requiring banking institutions to double count their liquidity exposure to this particular category of assets. We therefore recommend that for the purposes of calculating liquidity over the one-year NSFR time horizon, goodwill and other intangible assets should be excluded from Required Stable Funding.

Thank you once again for the opportunity to comment on the important matters raised within this Consultative Document. To summarize, State Street recommends a number of targeted revisions to the Basel Committee’s proposed framework. This includes the treatment of custodial deposits in a manner similar to other operationally-linked deposits, the treatment of committed lines of funding to mutual funds and other similar entities in the same manner as funding provided to non-financial corporates, and the more expansive definition of high-quality liquidity assets, notably via the inclusion of agency sponsored MBS. In addition, we recommend the provision of a liquidity credit for scheduled amortizations and expected pay-downs on investment securities held, regardless of the underlying term to maturity, as well as the consistent treatment of goodwill and other intangible assets.

Please feel free to contact David Silk in our Treasury Department (djsilk@statestreet.com) should you wish to discuss State Street’s submission in greater detail.

Sincerely,

Stefan M. Gavell