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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

RE: Consultative Document on Global Systemically Important Banks

Ladies and Gentlemen,

The Bank of New York Mellon, State Street Corporation, and Northern Trust Corporation (collectively "Specialized Custody Banks") are regulated U.S. bank holding companies that specialize in providing custody, payment processing, cash management and investment management services to financial institutions, corporations, and institutional investors. The Specialized Custody Banks are subject to U.S. and host country supervision and regulation, including the Advanced Capital Adequacy Framework of Basel II and related capital adequacy guidance. As a group of Specialized Custody Banks, we appreciate the opportunity to comment on the Consultative Document; "*Global systemically important banks: Assessment methodology and the additional loss absorbency requirement ("G-SIB Capital Proposal" or "the Proposal")."*

Over the years, the Specialized Custody Banks have worked with regulators and industry groups to develop and implement capital adequacy frameworks at their respective institutions consistent with the principles set forth by the Basel Committee on Banking Supervision ("BCBS" or "the Committee"). We recognize the challenges supervisors confront in developing simple concrete metrics to identify and assess capital for systemically important financial institutions in an open and transparent manner. This task is especially difficult as market and competitive dynamics encourage and necessitate changing risk profiles among financial institutions and the assessment of systemic risk will, by its nature, be time varying and dependent upon the economic environment. The Proposal advances this difficult task.

We understand the BCBS's conceptual basis for measuring systemic importance using the five proposed categories. However, we believe there are a number of opportunities to improve the proposed indicators to make them more risk sensitive and meaningful in arraying institutions based on systemic risk. In particular, we believe there are significant opportunities to improve the indicators used to measure the Substitutability of bank activities that can contribute to systemic risk.

Most notably, we believe the use of Assets Under Custody 'AUC' duplicates risks covered by other indicators and overstates the nature of the systemic risks posed by

custody services. We do not believe a broad metric such as AUC merits inclusion in a limited set of key indicators that address the contribution substitutability can make to systemic risk. We therefore encourage the BCBS to reconsider the critical activities captured in the indicators for substitutability to be more consistent with the purpose for this category.

We also believe that there are opportunities to improve the risk sensitivity of the three indicators proposed for measuring Interconnectedness and to make them more consistent with the identification of systemic risk and established BCBS standards.

1. Substitutability

As cited in the Proposal, the BCBS has drawn heavily from the 2009 IMF/BIS/FSB report[1] submitted to the G20 Finance Ministers and Central Bank Governors in specifying the Size, Interconnectedness and Substitutability categories. However, the proposed indicators within the Substitutability category do not fully incorporate the basic concepts discussed in that report surrounding substitutability, but rather appear to inappropriately carry over some examples used in the report without full consideration of their inter-relationships with other indicators of systemic risk. Important considerations the BCBS should take into account before finalizing the indicators to be used for the Substitutability category include the following:

- *The complete consideration of the broad array of critical activities performed by banking organizations:* The proposed assessment indicators do not consider the full population of critical activities where systemic risks related to substitutability should be assessed. Furthermore, with regard to custody services we believe these risks are overstated, especially given the existence of contingent operating plans and appropriate recovery and resolution plans. As a result of such efforts, the failure of a custodian poses less systemic risk than other critical banking activities.

- *The overlap of custody risks with other proposed indicators:* The systemic risks arising from custody services are already captured in other indicators, and the inclusion of AUC as an indicator therefore leads to double counting.

- *The substitutability of custody services relative to other critical activities:* Custody services are more substitutable than assumed in the Proposal.

The following comments further expand on these considerations and our recommendations for refinements to the framework.

[1] Report to G20 Finance Ministers and Governors: Guidance to Assess the Systemic Importance of Financial Institutions, Markets and Instruments: Initial Considerations

Complete consideration of the broad array of critical activities performed by banking organizations

Paragraph 35 of the Proposal describes the rationale for the substitutability indicators as follows:

> *"The systemic impact of a bank's distress or failure is expected to be negatively related to its degree of substitutability as both a market participant and client service provider. For example, the greater the role of a bank in a particular business line, or as a service provider in underlying market infrastructure, e.g., payment systems, the larger the disruption will likely be following its failure in terms of both service gaps and reduced flow of market and infrastructure liquidity."*

In its identification of a select group of indicators, the Proposal considers only a limited number of bank activities that meet the description presented in Paragraph 35. Drawing from the 2009 G-20 report, attributes of substitutability that might contribute to systemic risk are those that (1) institutions or customers may find hard to replace in a timely manner, often due to operational considerations, and (2) are offered in highly concentrated markets. In light of these criteria, the limited number of bank activities proposed as the indicators in this category does not reflect the universe of critical activities where substitutability should be considered. Examples of other critical activities where lack of substitutability could create systemic risk include market making in certain securities and derivative instruments, and several types of commercial and retail lending activities, to name a few.

Importantly, the servicing and management of assets included in providing custody services does not entail principal risk. Institutions providing custody services do not assume the risk for their customer's custody assets and do not hold client custody assets on their own balance sheet. This segregation results in assets under custody remaining available to customers in the event of a custodian failure. The risk associated with a custodian failure for institutional investors is one of short-term operational inconvenience rather than credit losses. The uninterrupted provision of custody services in the event of the failure of an institution offering custody services is already being actively addressed in institutions' development of their recovery and resolution plans under U.S. and international supervisory and regulatory provisions.[2]

In considering the appropriate indicators for the assessment of substitutability, we believe the Committee should evaluate a more comprehensive list of critical activities undertaken by global banking organizations. Consistent with the G-20 Report, this more complete list of potential critical activities meriting assessment should consist of products and / or services that cannot be easily replaced in a timely manner due to operational

[2] The Specialized Custody Banks also operate under the U.S. Interagency Paper on Sound Practices to Strengthen the Resilience of the U.S. Financial System issued May 28, 2003. This guidance identifies two sets of firms: "core clearing and settlement organizations" and "financial firms that play an important role in critical financial markets." The guidance is focused on resilience and recovery and preventing disruptions in the key types of services that these firms provide. Capital is not mentioned under this guidance as it is not seen as a mitigating control for these activities.

considerations that are also offered in a highly concentrated product or service offering market.

Efforts should also be made to ensure that the systemic risks entailed in these activities do not overlap with other critical activities. A viable list of activities could be those required to be addressed in bank recovery and resolution plans. The Financial Stability Board's ("FSB") consultative document on resolution planning[3] requires banking organizations developing resolution plans to "identify financial and economic functions for which continuity is critical."[4] In providing guidance on such functions, individual country supervisors have recognized much broader sets of critical economic activities than are represented in the proposed indicators. We recommend that such emerging lists of critical activities be more fully assessed in selecting the indicators for measuring substitutability.

Overlap of custody risks with other proposed indicators

In selecting critical banking activities as indicators, efforts should also be made to ensure that the systemic risks entailed in some activities are not already captured in other indicators. The inclusion of AUC as an indicator leads to double counting of the risks associated with the components of custody services. These risks are already suitably captured in other indicators included in the substitutability and interconnectedness categories. Custody service components include: 1) transaction processing and settlement; 2) safekeeping and reporting, and, 3) banking services. All three of these activities are already captured in the payment system substitutability indicator and the intra-financial systems assets and liabilities indicators specified for the interconnectedness category. As a result, the inclusion of assets under custody as an indicator of substitutability is duplicative in its assessment of systemic risk.

Substitutability of custody services relative to other critical activities

Relative to other critical economic activities performed by banks, custody services are also more substitutable than appears to be assumed by the designation of AUC as an indicator.

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[3] For example, the UK Financial Services Authority ("FSA") in its August 2011 consultative paper on recovery and resolution plans recognizes a discrete set of example critical economic activities for banking organizations to consider. Financial Stability Board Consultative Document: Effective Resolution of Systemically Important Financial Institutions – July 2011

[4] Section 4.35 of the UK FSA Consultative Paper on Recovery and Resolution Planning includes the following examples of critical activities:

- Retail: (a) current accounts including overdrafts; (b) savings / time accounts; (c) lending: mortgages / other secured; (d) lending: unsecured personal loans; (e) overdrafts; (f) credit cards issuance and underwriting
- Wholesale: (a) corporate deposits; and (b) corporate lending
- Capital Markets Activities: (a) long term capital investment; (b) principal trading; and (c) debt and equity capital markets;
- Fee Based Activities: (a) credit card merchant acquiring / services; (b) payment services; (c) cash services; (d) third party services; (e) client asset management; (f) brokerage; and (g) custody services
- Insurance Activities: (a) general insurance, re-insurance, underwriting and / or broking services; and (b) life pensions, annuities and investments
- Other Critical Activities: (a) corporate advisory services; and (b) research

Because customer assets are segregated, they remain available to customers in the event of a custodian failure. If a bank providing custody services were to fail, custody services operations would generally continue and as noted earlier, provisions for this continuity are being actively addressed in our development of recovery and resolution plans. Moreover, these services are viewed as transferable to other providers under a reasonable timeframe given the following factors:

- The provision of custody services is a readily scalable, uniform business that would permit other firms to absorb additional custody business in a time of stress, unlike more balance sheet and capital-intensive activities such as lending or derivatives

- The custody franchise of a distressed financial institution can generally be successfully separated from other assets and liabilities, and is likely to be an attractive asset to potential acquirers. The Specialized Custody Banks are only moderately sized by global standards and do not rank in the top 50 global banks based on asset size.

- With regard to alternative providers, there are more than 50 banks globally providing custody services and many large institutional investors already use multiple custodians.

Recommendations for refinements to the Substitutability category

Given these considerations, we ask the BCBS to reconsider the selection of Substitutability indicators and adopt a revised risk-based approach that more appropriately recognizes the differences between custody services and other critical activities engaged in by banking organizations. As currently constructed, the Proposal appears to focus on limiting the systemic risk indicators to three or fewer per category. Based on the risk characteristics measured by AUC, the coverage of the same risks by other indicators, and the general substitutability of custody services we do not believe AUC merits inclusion among the three most critical activities contributing to systemic risk from a substitutability perspective, and it is therefore inappropriate to include AUC as a substitutability indicator.

2. <u>Interconnectedness</u>

The Specialized Custody Banks acknowledge that interconnectedness is an important contributor to systemic risk and recognize the merits of the concepts each of the proposed indicators attempts to measure. To improve the effectiveness of these indicators we suggest that the BCBS consider the following improvements to the proposed indicators of Intra-financial System Assets, Intra-financial System Liabilities and the Wholesale Funding Ratio.

Interconnectedness – Intra-Financial System Assets and Liabilities

The Specialized Custody Banks recognize the Committee's desire to measure interconnectedness using an assessment of a banking organization's intra-financial system assets and liabilities. However, we also believe the Proposal does not sufficiently define "Financial Institution" within the context of these indicators. Per Paragraph 29 of the Proposal:

> *"Financial distress at one institution can materially raise the likelihood of distress at other institutions given the network of contractual obligations in which these firms operate. A bank's systemic impact is likely to be positively related to its interconnectedness vis-à-vis other financial institutions."*

In its assessment of interconnectedness, we recommend that the Proposal better define "Financial Institution" in designating the assets and liabilities to be included in these indicators. For example, it is unclear the extent to which the definition of "Financial Institution" includes collective investment vehicles such as mutual funds, collateral investment pools, or other types of private funds and investment vehicles.

Given the focus on systemic risk, the universe of interconnected financial assets and liabilities should be limited to those assets and liabilities an institution holds that are direct obligations or assets of other designated global systemically important institutions – not all financial institutions. Recognizing this, the designers of Section 165(e) of the US Dodd-Frank Wall Street Reform and Consumer Protection Act constructed credit exposure monitoring requirements and credit exposure limits in the context of exposures to other systemically important institutions. In the absence of this refinement in the definition of a Financial Institution, the implementation of the intra-financial system asset and liability indicators may unduly overweight credit extensions to smaller financial institutions and various types of financial entities that pose limited systemic risk.

Interconnectedness – Wholesale Funding Ratio

We recognize the Committee's desire to include an institution's liquidity risk profile and exposure to potential volatile funding sources in assessing the organization's systemic risk profile. As the Proposal notes:

> *"One of the main experiences of the recent crisis was that a market run on an institution whose illiquid assets were financed by short-term liquid liabilities (i.e., an institution with a high wholesale funding ratio) spread quickly and widely to other institutions and markets."*

The important role that liquidity mismatches of financial institutions can play in amplifying solvency concerns and systemic risk was a primary reason the BCBS advanced the Basel III liquidity standards. As that effort showed, measuring the liquidity risk profile of an institution can be a complex and difficult task, especially with respect to properly defining behavioral characteristics of assets, liabilities and off-balance sheet positions. These standards also emphasize the important risk-mitigating role played by cushions of

high quality liquid assets. From a consistency standpoint, the simple metric proposed for the wholesale funding ratio should, at a minimum, incorporate the subtraction of level 1 and level 2 liquid assets from the wholesale liabilities derived by subtracting retail deposits from total liabilities.

Moreover, as this indicator is implemented, supervisors will need to appropriately define "retail" and "wholesale" deposits used in the simple wholesale funding ratio proposed. We believe that the substantial work of the BCBS's working group on liquidity should be leveraged in specifying these definitions by incorporating the concepts of "stable" and "less stable" used in both wholesale and retail characterizations. Per Paragraph 34 of the Proposal, the wholesale funding ratio would be calculated as follows:

> *"The wholesale funding ratio is calculated by dividing (total liabilities less retail funding) by total liabilities. Retail funding is defined as the sum of retail deposits (including certificates of deposit) and debt securities issued that are held by retail customers. The indicator for the bank is normalized by the average ratio across all banks in the sample."*

While we agree that the wholesale funding ratio indicator should recognize the more stable retail deposit base, we do not believe that the balance of non-retail total liabilities exhibits a single uniform run-off behavior. We believe that non-retail liabilities exhibit a spectrum of run-off behaviors resulting in different retention rates of stable versus less-stable deposits, rather than a simple wholesale versus retail behavior. For example, the indicator does not recognize the observed "stickiness" of operational deposits that was integrated into the liquidity requirements of Basel III. At the same time, we recognize it is not possible for each banking organization to apply its own unique deposit run-off assumptions to the wholesale funding ratio calculation. Rather, we believe a more sensitive run-off measurement should be considered to more effectively estimate the wholesale funding dependence of a banking organization relative to other financial institutions.

In considering alternative measurement approaches for the calculation of the wholesale funding ratio, we believe the work related to the Basel III liquidity coverage ratio has set a precedent for distinguishing stable versus less-stable deposits, which we believe should be applied in this context. As such, one potential alternative is to leverage the Basel III approach for net cash outflows[5] that gives each deposit type a different run-off factor (e.g., operational deposits = 25%). In this way, the proposed wholesale funding ratio would exhibit more run-off sensitive deposit behavior relative to the existing metric.

[5] The net cash outflow factor included as part of the Liquidity Coverage Ratio from Basel III: International framework for liquidity risk measurement, standards and monitoring (BCBS release 188, paragraphs 50-87) includes the following run-off / drawn down rates for outstanding balances of various categories or types of liabilities and off-balance sheet commitments:

- Stable deposits (retail) = 5%
- Less stable deposits (retail) = 10% and higher
- Unsecured wholesale funding by small business = 5%, 10% and higher
- Unsecured wholesale funding with operational relationships = 25%
- Unsecured wholesale funding provided by non-financial corporate and sovereigns, central banks and public sector entities = 75%
- Unsecured wholesale funding provided by other legal entity customers = 100%

Conclusion

We commend the Committee on its continued efforts to strengthen the capital position of the global banking system and appreciate the opportunity to comment on this Proposal. We believe the comments noted above represent reasonable and warranted modifications to the proposed G-SIB assessment criteria and related indicators. We look forward to the Committee's response to this and other comment letters.

Sincerely,

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