June 28, 2013

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

Re: ***Supervisory framework for measuring and controlling large exposures***

Dear Sir or Madam:

The Bank of New York Mellon Corporation, Northern Trust Corporation, and State Street Corporation (individually **BNY Mellon, Northern Trust and State Street**, collectively, the **"Custody Banks"**) are pleased to have the opportunity to provide comments to the Basel Committee on Banking Supervision (the **"Committee"),** with respect to the Consultative Document entitled *Supervisory framework for measuring and controlling large exposures* (the **"Consultation"**).[1] We understand and accept the core rationales of the Consultation; the need to contain the potential losses a bank could face in the event of a sudden counterparty failure and to reduce contagion risks. The Custody Banks believe that such a regulatory focus is not only appropriate given the financial crisis, but also necessary to ensure financial stability. Indeed, our internal risk management and credit exposure processes already include the robust management of our counterparty exposures.

Though we support the general aims of the Committee's work, we believe that certain components of the proposed framework require a fundamental rethinking. Our primary concern is that the Consultation significantly overstates the credit exposures associated with securities finance transactions (**"SFTs"**).[2] We feel that the Committee's approach is overly blunt and could have significant impacts on the securities lending market, agent securities lenders, and the customers we serve. We recommend that the Committee permit the use of credit exposure measurement methodologies for SFTs that firms have developed to comply with risk-based capital requirements.[3] Should the Committee feel that those models inadequately

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1 The provision of custodial and trustee services to our institutional clients is a significant component of each of the Custody Banks' businesses. Collectively, we service over $50 trillion of assets held globally under custody or administration ("AUCA").

2 Our comments focus predominantly on our concerns with the proposed treatment of securities lending, but are more broadly applicable. The substance of our concerns extend to the application of the proposed framework to all transactions commonly considered "repo-style", including repurchase or reverse repurchase transactions, securities lending and borrowing, and margin lending transactions.

3 The Custody Banks, like all advanced approaches banking organizations, have made significant investments in developing these models and in ensuring they pass supervisory muster. That collaborative process between the industry and supervisors should continue.

capture the tail risk associated with SFTs, the Custody Banks urge the adoption of a more risk-sensitive approach based upon Value at Risk (**"VaR"**) principles.

Also troubling to us is the potential for the operations of custody banks to be disproportionately impacted by the proposed exposure regime. The Consultation's approach to defining and regulating credit exposures does not fully consider the adverse impacts on the payment, clearing, and settlement functions that are core to the provision of investment services, including custody and safekeeping, to our clients. The Consultation would be materially improved if it included a formal, time-limited exemption for operational overages of exposure limits related to these activities.

In addition, the Custody Banks strongly support the introduction by the Committee of a full exemption for bank exposures to a qualifying central counterparty (a **"CCP"**). This is to help facilitate the orderly transition of the market to a centrally cleared model, and to facilitate our ability to support end-users and buy-side clients that are not in a position to become direct clearing members.

Further, we believe that the composition of the proposed exposure limit's denominator should be reconsidered to account for all of the loss absorbent capacity held by banks. Specifically, the denominator should be revised to include total regulatory capital and loss reserves. On a related calibration issue, the Custody Banks recommend that the Committee align any new credit exposure regime for global systemically important banks (**"G-SIBs"**) with its approach to capital surcharges to the same cohort of banking organizations so that the credit exposure framework accurately accounts for the systemic risk profile of each individual G-SIB .[4]

Our comments are organized into three parts. Part I focuses on the Consultation's treatment of SFT exposures. Included within Part I is an explanation of a potential alternative approach to calculating such SFT exposures. Part II addresses our concerns with the framework's treatment of core custody functions. In particular, we focus our comments on impacts related to payment, clearing, and settlement activities, as well as the treatment of exposures to CCPs. Last, Part III explains our calibration concerns, focusing the treatment of custody banks that are also G-SIBs and on potential revisions to the exposure ratio's denominator.

Part I: The Consultation significantly overstates credit exposures associated with securities finance transactions

The Consultation's treatment of SFTs, particularly agent securities lending dealings, deviates from the risk-based capital requirements and injects unnecessary imprecision into credit exposure calculations. While the Committee correctly notes that the global banking organizations covered by the Consultation have three options for measuring SFT exposures under the risk-based capital framework, it eschews a models-based approach due to the faulty premise that supervisor-approved models result in the imprecise assessments of credit risk. We believe the opposite is true: forcing the Custody Banks to use measurement methodologies that ignore the volatility of loan and collateral positions and, when non-cash collateral is taken, fail to reflect correlations between loaned and accepted securities, will hamper the effective assessments and management of risk. Simply put, as proposed, the credit exposure limits discourage correlated and diversified SFT positions.

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[4] To the extent this commentary addresses the treatment of G-SIBs, the views presented are those of BNY Mellon and State Street. Northern Trust is not a G-SIB.

A. Securities Lending Provides Meaningful Benefits to Financial Markets

Securities lending plays a critical role in the efficient functioning of financial markets. It helps facilitate the timely settlement of securities transactions, as well as the conduct of both market making and hedging activities. In addition, securities lending provides important benefits to institutional investors, such as retirement plans and mutual funds, by enabling the generation of low-risk, incremental returns on investment portfolios. These returns are used to enhance investment performance and offset administrative and other portfolio costs. All of these benefits cannot flow to market participants if the banks charged with intermediating lending and borrowing are unnecessarily constrained.

The benefits of securities lending are well known not only to the markets, but also to the supervisory community. Various regulatory bodies have analyzed securities finance transactions and concluded that the operations of agent lenders are crucial to well-functioning markets. Just last year, the Federal Reserve Bank of New York (the **"FRBNY"**) studied the repo and securities lending markets and determined that the services the Custody Banks provide are necessary for both fixed income and equity markets.[5] Moreover, the FRBNY noted that securities lending is especially important to creating liquidity in markets for sovereign bonds, providing broad benefits concerning price discovery, efficiency and market liquidity.

Abandoning the regulatory paradigm traditionally applied to securities lending operations would be contrary to the best interests of market participants, market stability and abiding supervisory consensus.[6]

B. The Proposed Measurement Methodologies for SFTs Require Reconsideration

The Custody Banks believe that relying on blunt measurement tools will force banks to substantially reduce agency indemnified securities lending activity. This will, in turn, result in significant negative market impacts. Specifically, we are concerned that financial markets will lose the efficiency and liquidity benefits attributable to SFTs. Divorcing the credit exposure framework from the actual risks associated with SFTs will come with real consequences for financial markets.

The Consultation's treatment of SFT exposures is lacking in several respects. In the aggregate, these inadequacies result in an incomplete picture of the actual risks that arise from the economics of a securities lending trade. That incomplete picture produces exposure calculations that overstate the realities of risk in SFTs. Aside from the broad – and seemingly intentional – risk insensitivity of the SFT measurement approach, we are also concerned that the proposed exposure framework fails to recognize correlation benefits and the full risk-mitigating impacts of legally enforceable netting arrangements. Indeed, our understanding of the "Comprehensive Approach" prescribed in the Consultation is that it provides very limited opportunities to net transactions, restricting such netting to individual CUSIPs within a netting

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5 Federal Reserve Bank of New York – Staff Reports – Repo and Securities Lending (January 2012).

6 For instance, CPSS-IOSCO has gone as far as to state that "securities lending and borrowing...should be encouraged as a method for expediting the settlement of securities transactions. Barriers that inhibit the practice of securities lending for this purpose should be removed." Recommendations for Securities Settlement Systems (November 2001).

set. Finally, the Consultation's requirement to capture exposures of the collateral issuer is overly punitive because it overlooks the double default nature of indirect risk exposures.

C. The Committee Should Consider Alternative Measurement Approaches

We believe the optimal approach the Committee should take is to permit banks to use existing Simple VaR models. Unlike the Basel II Comprehensive Approach, VaR methodologies possess several features that make them particularly well-suited to measuring counterparty exposure in SFTs. This includes market-driven data inputs that reflect, among other features, the short duration of most securities loans. In addition, VaR methodologies appropriately capture the correlation between securities lent and collateral received. VaR methodologies therefore serve as a far more accurate measure of risk than the approach envisioned by the Committee.

Using internal models provides important benefits to the securities lending market. The undergirding principle is simple: reflecting the actual risk of SFTs leads to sounder business practices and risk management. The converse is equally true; if firms are forced to use intentionally risk-insensitive measurement methodologies, the Committee will actually be encouraging uncorrelated and riskier positions. The haircut approach recommended by the Committee will likely come with the negative consequences of riskier securities finance behavior and reductions in market liquidity.

Though we believe that the use of existing Simple VaR models is the most sensible approach for the Committee to take, we understand that the financial crisis has led to a reconsideration of internal model usage and supervisory worries regarding the adequacy of modeling capabilities. We accept the supervisory concern that internal models do not always capture tail risks and that model development can become homogeneous. But it is necessary to balance those supervisory concerns against the demonstrable benefits of more risk-sensitive measurement approaches. The Custody Banks note, in this respect, that it is possible to develop an alternative approach that is both risk-sensitive and that provides for greater standardization. In turn, such an approach will allow for consistent and accurate horizontal risk comparisons by supervisors. To achieve such balance, the Custody Banks recommend that the Committee strongly consider the use of VaR models that use supervisory inputs (a **"Supervisory Inputs Approach**").

Under this approach, regulators would specify the inputs for various components of banks' internal models. These directed inputs include market-based volatility factors, correlations between securities lent and collateral received, the benefits of portfolio diversification, and other relevant risk adjustments. Using a Supervisory Inputs approach would come with several benefits. For instance, the inputs would be inherently more dynamic and risk-sensitive than the Consultation's proposed static inputs. From a supervisory perspective, our proposed measurement framework would also ensure consistency across firm modeling practices and allow greater comparability. Requiring uniform modeling assumptions will result in easier data comparisons and reduce concerns around model arbitrage. Concurrently, such models would also provide supervisors with the flexibility to adjust inputs during periods of market stress.

While important benefits would flow from the adoption of the Supervisory Inputs Approach, there are other possible alternatives for the measurement of SFT exposures, and we urge the Committee to explore these solutions. This could include a thorough recalibration of

the proposed standardized haircut matrix based on various loan and collateral combinations that reflect the supervisory inputs noted above. Whatever the alternative used, the methodology should be designed to strike an appropriate balance between simplicity and risk sensitivity. In the interim, the Custody Banks should be permitted to continue making use of their supervisory approved simple VaR methodologies. This is consistent with the intended treatment of derivatives, where the Committee foresees the use of existing internal models based approaches, until the adoption of an appropriate successor to the standardized current exposure method.

Making the exposure framework more risk-sensitive will not, in our view, undercut the Committee's legitimate objectives of ensuring financial stability and reducing systemic risk. Rather, it would inject conservatism and uniformity into existing modeling practices. We would direct you, in this respect, to the analysis included in the commentary of the Risk Management Association, which indicates that during periods of stress, even if asset values decrease, relying on a more risk-sensitive methodology like the Supervisory Inputs Approach would reduce, rather than increase, risk.

Beyond our technical concerns, we believe it is important to note that in the context of SFTs, the intended credit exposure framework will not operate as the Committee believes. The proposed exposure methodology overstates the credit exposures associated with SFTs to such a significant extent that it will become the binding constraint on agent securities lenders. As a result, the exposure framework will not serve as a backstop and complement to the risk-based capital rules, but will supersede them. Paradoxically, it is the intentionally blunt measurement approach that causes the Consultation's proposed limits to serve as the primary constraints on agent lender activities. We believe this anomalous result demonstrates the necessity of a fundamental re-evaluation.

Part II: The Consultation necessitates revisions to account for the unique operations of custodial firms

A. The Exposure framework should formally exempt short-term exposures arising from market settlement anomalies

Fundamental to the custodian-customer relationship are the provision of investment services such as settlement, safekeeping, and asset administration. Also core to the custody relationship are various cash management functions, such as the receipt of income and other interest payments, foreign currency transactions, client subscriptions and redemptions, and other routine payment activities. Due to the nature of the services we provide, the Custody Banks are of central importance to the smooth operation of financial markets.

Custody banks must be able to incur short-term counterparty exposures related to the aforementioned core transactional services, without the prior approval of home or host country supervisors.[7] This is because payment, clearing, and settlement services are not immune to rare operational interruptions. Nearly all client transactions undertaken by custody banks settle as

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[7] In addition to possible overages that result from our core custody functions, we also wish to note that the Custody Banks' broader processing and settlement functions offer unique insights into the Committee's deliberations concerning intra-day and overnight exposures to other financial institution counterparties. In view of the payment, clearing and settlement activities undertaken on behalf of our clients, we strongly endorse the Committee's adoption of a limited exemption for intra-day and certain overnight exposures. This includes an exemption for the overnight balances held by the Custody Banks in *nostro* accounts at agent banks globally.

expected and only result in intra-day exposures. Occasionally, a transaction may be delayed or fail due to timing, matching, systems or other similar impediments.

Unexpected operational exposures can occur in several different contexts. Take for instance the common services the Custody Banks provide to large state pension funds. One can imagine such a fund with $200 billion in combined assets that generates exposures of 7% of the custody bank's Tier 1 Common Equity (**"CET1"**). Consider, in turn, the consequences of several rare, but plausible, events occurring on a particular day:

- An investment manager purchases U.S. Treasuries (**"USTs"**) across a number of funds, equaling less than 2% of the collective funds' assets, but 20% of the bank's capital, with the intention of selling these to brokers under reverse repurchase agreements. The buy trades do not settle with the custodian until after it is too late to make delivery on the sell trade or reverse the buy trades back to the broker. This would cause the collective funds to be long the UST positions, and the client's demand deposit accounts to be overdrawn.

- Monthly benefit payments totaling 15% of the bank's capital occur across a large number of collective fund accounts. Individually, the wires settle automatically based upon settlement rules that take into account counterparty rating and asset value relative to the wire size, but failure of trades to fund the wires causes the collective fund deposit accounts to be overdrawn.

Though the likelihood of wholesale failed trades is low and the collateral protections afforded to custody bank are strong, these combined events could cause the custody bank's exposures to the client counterparty to temporarily rise above the applicable large exposure limit. As a result, the custody bank would need to either withhold payments or cancel buy-trade transactions, impeding the smooth operation of the financial system.

These circumstances are purely operational and are no more common during periods of market stress. Since these exposures typically arise due to unexpected matters and are generally only apparent after relevant settlement times, it is beyond the control of a custodian to immediately eliminate or reduce these exposures. Operational exposures are always short-term and are generally secured by a lien on client assets. While these types of operational delays may create unintentional, temporary exposures, applying the large exposure regime to them will not result in any appreciable added value, operational certainty, or risk reduction. Therefore, we recommend that the Committee include within its large exposure framework a time-limited exemption for the exposures that internationally active banks may incur when providing payment, clearing and settlement services on behalf of their clients.

We cannot stress enough that the Committee's inclusion of such an exemption would merely be an acknowledgment of the realities of the existing global financial infrastructure and not a weakening of the large exposure framework. Indeed, all of the Custody Banks have robust risk frameworks in place that set internal limits and address limit exceptions and other aspects of the custody and investment services they provide to their customers. This includes policies and procedures adopted on an *ex ante* basis and in accordance with existing home and host supervisory guidelines that govern the extension of immediate or provisional credit to facilitate day-to-day transactional activities. Requiring custody banks to operate on behalf of their clients – without the ability to extend short-term transactional credit beyond the prescribed large exposure limits – will necessitate fundamental changes in current practices that will increase systemic risk, raise costs for customers, and eliminate market efficiencies.

To facilitate the development of an exemption for temporary breaches of exposure limits, we reviewed our operations and client-support functions to determine appropriate criteria for use in circumscribing limited relief. When settlement failures do occur, they can cause aggregate exposures that would breach the proposed limits for several days, even though the initial underlying transaction causing the exposure may have cleared. The potentially longer breach period is due to the continual investment activities in client accounts. Compelling the immediate cessation of securities settlement and other operational activities for our clients could cause significant market disruptions. Custody operations require the flexibility to incur additional transactional exposures to a single counterparty client when already above the aggregate large exposure limit, provided that adequate policies and procedures are in place to reduce the exposure in a timely manner.

We recommend that the Committee include within the large exposure framework, an exemption from single counterparty concentration limits when:

- The exposure arises in the normal course of providing payment, clearing or settlement services to clients, including in respect of foreign exchange, securities, derivatives, commodities and similar investment activities;
- The bank has policies and procedures in place that appropriately govern the credit and liquidity risks of the counterparty, and that it monitors such exposures on a daily basis;
- To the extent that the aggregate exposure to the counterparty exceeds the large exposure limit, that the bank takes appropriate action to reduce the exposure as quickly as reasonably practicable, and in any event within five business days of the initial breach[8]; and
- The bank reports the large exposure excess to its national supervisory authority not later than the first business day after the excess occurs, and advises as to the actions it has or will take to promptly eliminate the exposure within the prescribed five day period.

B. CCPs should be subject to Pillar 2 supervisory limits and not a rigid Pillar 1 requirement

The Custody Banks support the regulatory policy objective of encouraging the migration of derivatives transactions to CCPs. We therefore welcome and strongly support the second of two alternative treatments proposed by the Committee, namely that qualifying CCPs not be subject to any Pillar 1 "hard exposure limit", but rather to a supervisory reporting obligation.

As noted, the development of CCPs is at the heart of the capital markets reforms enacted since the financial crisis. It is unclear to the Custody Banks what marginal risk-reduction benefits would occur if exposures to "qualifying" CCPs were included in the credit exposure limits. In fact, we are concerned that forcing the inclusion of such exposures may actually have the unintended consequences of dissuading firms from pursuing the centralized clearing of derivative transactions, including on behalf of end users and buy-side investors, and may also result in unwarranted fragmentation in the clearing markets.

[8] Permitting a five-day cure period is consistent with the regulatory capital rules' approach to the treatment of unsettled securities transactions.

Part III: The credit exposure limits' denominator should be recalibrated to more accurately reflect the loss absorbing capacity of bank balance sheets and the uniform treatment of G-SIB exposures should be replaced with a graduated approach

The Committee proposes to limit large exposures according to the narrowest capital base possible, either CET1 or total Tier 1 capital. Though we recognize the regulatory desire to require firms to possess enough loss absorbing capacity to withstand a major counterparty failure, we believe that the proposed denominator is overly conservative. The banking organizations to which the exposure framework will apply should be able to absorb losses - on a going concern-basis –beyond either CET1 or Tier 1 capital. The Custody Banks therefore recommend broadening the limit's denominator to include total regulatory capital and excess loan loss reserves, to reflect the full cohort of resources that can absorb losses.

The Consultation itself notes that it is appropriate to calculate the exposure limits according to "capital that can absorb unexpected losses on a going-concern basis." It then pivots to state that other components of capital and general provisions should be excluded from the definition of capital for large exposure purposes because they cannot absorb unexpected losses. We believe this logic is faulty for several reasons. The post-Basel III components of Tier 1 capital that do not count as CET1 – namely, perpetual noncumulative preferreds – are designed to provide loss absorbency on a going concern basis. The same is true of provisions. Failing to provide for loss reserves in the denominator will also create competitive distortions. National supervisors have spent decades developing robust policies, rules and expectations concerning general provisions. These varying approaches dictate reserve practices; excluding the loss absorbing capacity of general provisions will penalize firms operating in jurisdictions that require conservative reserve practices for safety and soundness reasons.

Moreover, the Committee makes clear throughout the Consultation that the large exposures framework is designed to serve as a backstop to the risk-based capital requirements. To do so, the exposures regime focuses on the *maximum* losses a banking organization could incur due to a major counterparty failure. The concept of maximum losses must, by definition, include both expected and unexpected losses. Therefore, the fact that general provisions are set aside for expected losses does not require their prohibition.

As conceived, the Consultation treats all G-SIBs the same, without any regard for the varying degrees of systemic importance among them. In this regard, the large exposure regime deviates from the G-SIB capital surcharge framework, which acknowledges the reality that all global banking firms are not the same. BNY Mellon and State Street feel that a pragmatic exposure regime should draw on elemental first principles, particularly the fact that G-SIBs vary in size, complexity, operations, and capital markets activity. Indeed, the G-SIB group contains universal banks, trading banks, custody banks, and largely retail banks. Axiomatically, these differences lead to varying consequences when a large counterparty unexpectedly fails. Because the operations of custody banks are different from larger universal or trading banks, we believe different G-SIB large exposure limits are warranted.

Rushing to enact a universal 10%-15% large exposure limit, irrespective of the risk profiles of individual G-SIBs, could create significant dislocations in the provision of core custody functions and impact broader payment, clearing, and settlement operations.

If it is the Committee's view that certain banking activities require stricter exposure limits, BNY Mellon and State Street recommend that the 25% limit be retained for G-SIBs that are organized and operate as global custodians. This approach would be more consistent with the tiered approach found in the capital surcharge framework. Similarly, BNY Mellon and State Street would also support the more formal "bucketing" paradigm used in the context of the G-SIB capital surcharges. Under this alternative, the Committee would place G-SIBs within several exposure limit buckets, ranging from 15%-25%, according to their systemic importance. This would include an assessment of a G-SIB's scope of cross-jurisdictional activities, balance sheet size and composition, financial interconnectedness, organizational and financial complexity, and substitutability.

Conclusion

In summary, we urge the Committee to modify the proposed large exposures framework to:

1. Align the measurement of credit exposures for securities lending and similar SFTs with the actual risk of the transactions;
2. Include an exception for short-term exposures arising from the provision of settlement services to custody customers;
3. Subject CCPs to Pillar 2 supervisory limits;
4. Expand the exposure limits' denominator to total regulatory capital and loss reserves; and
5. Appropriately tailor limits applied to G-SIBs to account for differences in their systemic risk profiles.

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Thank you again for the opportunity to comment on matters of concern to the Custody Banks.

Should you have any questions, please feel free to contact Eli K. Peterson, Managing Director and Senior Managing Counsel of The Bank of New York Mellon at 202-624-7925 (e-mail: Eli.Peterson@bnymellon.com); James E. Roselle, Executive Vice President and Associate General Counsel of Northern Trust Corporation at 312-444-7565 (e-mail: jer7@ntrs.com); or Ken Sax, Senior Vice President -Enterprise Risk Management, State Street Corporation 617-664-8473 (e-mail: ksax@statestreet.com).

Sincerely,

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