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Secretariat of the Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel
Switzerland
Via e-mail: baselcommittee@bis.org

Consultative Document – Supervisory Framework for Measuring and Controlling Large Exposures

Dear Sir/Madam:

State Street Corporation ("State Street") welcomes the opportunity to comment on the Consultative Document ("Consultation") issued by the Basel Committee on Banking Supervision ("Basel Committee") regarding the measurement and control of large exposures. The Consultation envisions the introduction of a uniform 'simple' large exposure framework for internationally active banks, as a backstop to existing risk-based capital requirements. The large exposure framework is intended to mitigate potential bank insolvency risk, the risk of contagion among banks and risks that may materialize within the shadow banking system. The Basel Committee proposes to structure the large exposure framework as a Pillar 1 measure, in a manner consistent with existing regulatory capital requirements.

Headquartered in Boston, Massachusetts, State Street specializes in providing institutional investors with investment servicing, investment management and investment research and trading. With $25.4 trillion in assets under custody and administration and $2.2 trillion in assets under management, State Street operates in 29 countries and in more than 100 geographic markets.[1] State Street is organized as a United States ("US") financial holding company, with operations conducted through several entities, primarily its wholly-owned bank subsidiary, State Street Bank and Trust Company.

[1] As of March 31, 2013.

Our perspective in respect of the Consultation reflects our status as one of the world's largest providers of global custody services. As a global custodian, we maintain for our institutional investor clients an extensive network of sub-custodian and correspondent bank relationships, as well as direct and indirect links with financial market infrastructure ("FMI"), such as central securities depositories, international central securities depositories and central clearinghouses ("CCP"). Our clients include mutual funds, undertakings for collective investments in transferable securities ("UCITS") and other similar collective investment funds; alternative investment funds; corporate and public retirement plans; sovereign wealth funds; insurance companies; foundations and endowments. We appreciate the opportunity to offer insight relative to the impact of the proposed large exposure framework on our role as a custodial intermediary, a role that is widely understood by the supervisory community as providing important benefits for the safekeeping and administration of client assets.

INTRODUCTORY COMMENTS

State Street welcomes and supports the development of a globally consistent framework for the assessment of bank exposures to single name counterparty concentration risk. We recognize the importance of such a framework in the promotion of regulatory harmonization across national jurisdictions, in strengthening the resilience of internationally active banks, and in improving the stability of the financial system. Still, this requires an approach that is proportionate, that reflects the considerable progress made by banks in the measurement and control of their credit risk exposures, and that avoids unnecessary disruptions to financial markets.

This includes the greatest possible consistency with existing methodologies for the measurement of regulatory capital. Internationally active banks in the US are currently required to operate on the basis of numerous overlapping regulatory capital standards. This includes the Basel I and Basel II accords, the standardized and advanced risk-based methodologies and two distinct leverage ratios. This requires the maintenance, at significant cost, of disparate and often duplicative systems for the measurement of similar, if not identical, risk. The introduction of a large exposure framework that diverges from current regulatory capital requirements would simply compound this problem, with little or no offsetting risk mitigation benefits.

We believe that it is important to acknowledge that a uniform large exposure framework for internationally active banks is only one element of the ongoing global regulatory reform effort. As such, it should not be viewed as a 'simple' means of addressing all potential vulnerabilities in financial markets. We welcome the Basel Committee's decision to conduct a separate review of the appropriate treatment of sovereign concentration risk, including bank investments in sovereign debt instruments and central bank placements. In our view, it would be appropriate for any large exposure regime to incorporate a full exemption for bank exposures to highly liquid, high-quality sovereigns, defined on the basis of objective and consistent criteria. This reflects the importance of such sovereigns in the promotion of financial market stability, including as a reserve for excess bank liquidity. We recommend, in this respect, that the Basel

Committee provide national jurisdictions with sufficient flexibility to include, within the scope of the sovereign exemption, certain government-sponsored entities that either serve a significant public purpose or are otherwise closely linked with the underlying sovereign. This would include exposures to the Federal National Mortgage Association ("Fannie Mae") and the Federal Home Loan Mortgage Corporation ("Freddie Mac"), at least while each remains under the conservatorship of the US Department of the Treasury. Furthermore, State Street welcomes the Basel Committee's decision to exclude from the Consultation the complex issue of intragroup exposures.

Given the significant negative implications of an improperly calibrated framework for financial markets, we believe that it is essential for the Basel Committee to structure its large exposure methodology on the basis of clear empirical evidence rather than general policy goals. We therefore support the decision to conduct a detailed quantitative impact study, and also the proposal for a lengthy implementation timetable. Nevertheless, we are disappointed by the Basel Committee's decision to pre-emptively exclude supervisory-approved internal models from the large exposure regime, since this is likely to result in a significant and unwarranted overstatement of concentration risk. As a global custody bank, we are particularly focused on measures that would limit our ability to provide our institutional investor clients with well-established safekeeping and asset administration services.

This includes the proposed treatment of agency securities lending transactions, the treatment of exposures resulting from payment, clearing and settlement activities conducted on behalf of our clients and the treatment of exposures to CCPs. We also have important reservations regarding requirements relative to bank investments in collective investment undertakings, large exposure requirements for designated global systemically important banks ("G-SIBs") and other methodological concerns relating to the definition of connected counterparty, the treatment of financial collateral and the use of credit conversion factors ("CCF").

We have participated in the development of the detailed responses submitted by various financial services trade groups, and we generally support the observations and recommendations made therein. Our intention with this letter is to highlight issues of particular concern to State Street resulting from our custody bank business model.

SECURITIES LENDING TRANSACTIONS

The Basel Committee proposes to eliminate the use of internal models in the measurement of bank exposures to securities lending and repurchase transactions. Instead, internationally active banks would be required to make use of the Basel II 'Comprehensive Approach', with supervisory rather than own estimates of haircuts. While acknowledging that this represents a material 'deviation from risk-based capital requirements', the Basel Committee asserts that this is necessary to meet the objectives of the large exposure regime, which, at a high level, is to establish a 'backstop to risk-based capital requirements….so that the maximum possible loss a

bank could incur if a single counterparty or group of connected counterparties were to suddenly fail would not endanger the bank's survival as a going concern'.

We strongly disagree with the Basel Committee's approach and believe that the intended methodology for the measurement of exposures to securities lending transactions vastly overstates the 'maximum possible loss' that a bank may incur. The resulting inevitable contraction of the securities lending market is unnecessary to meet the Basel Committee's objectives, and will have significant detrimental impact on financial market liquidity and stability, as well as financial market participants, such as retirement plans, mutual funds and other institutional investors.

Existing Credit Exposure Measurement

Custody banks have long provided agency securities lending services to their institutional investor clients under the supervision of prudential regulators. The securities lending market is characterized by and subject to well-developed risk controls. This includes the over-collateralization of all securities loans with cash or other high-quality assets, the daily marking of all positions to market, and the re-margining of loans as appropriate to ensure ongoing over-collateralization. Custody banks often provide an additional layer of protection to their institutional investor clients by indemnifying exposures in excess of the value of the collateral received in the event of borrower default. Although important to the overall structure of the market, the risk of client indemnification is quite limited, with custody banks having rarely experienced more than *de minimis* securities lending-related losses.

Banks that are active in the securities lending market, including custody banks with large agency lending programs, typically use simple value-at-risk ("VaR") methodologies when calculating their counterparty credit exposures for capital purposes. These models were initially approved for use in securities lending and repurchase transactions by the US Federal Reserve Bank ("FRB") under Basel I. Similar methodologies have since been adopted by the Basel Committee, and incorporated into various national prudential frameworks as part of Basel II. These models, which State Street has used in various capacities since the mid-1990s, have evolved as banks and supervisors have developed additional expertise, including on the basis of ongoing, detailed regulatory scrutiny. They have benefitted from significant multi-million dollar investments and extensive systems upgrades.

The Proposed Comprehensive Approach

Under the Basel Committee's proposal, banks would be required to abandon these well-established, supervisory-approved methodologies in favor of a rigid and excessively conservative haircut-based approach that would dramatically overstate actual credit risk. As proposed, exposures to securities lending transactions would equal the difference between (i) the value of the securities lent, plus a standardized volatility factor, and (ii) the value of the collateral accepted, less a standardized volatility factor. This proposed methodology is severely flawed.

While we acknowledge the Basel Committee's willingness to forgo some level of risk sensitivity in favor of simplicity (and avoidance of model risk), the volatility factors incorporated in the Comprehensive Approach are highly arbitrary and excessively conservative. The prescribed factors have no empirical foundation, and do not reflect the typically very short duration of a securities loan. Under the proposal, an overnight securities loan is treated identically to a similar loan of much longer duration. In addition, the Comprehensive Approach provides very limited opportunities to net transactions, which is only allowed at the level of the individual security. As such, banks that are active in agency securities lending do not rely on the Basel II Comprehensive Approach, and have made significant investments in more risk-sensitive, supervisory-approved alternatives.

Furthermore, the Basel II Comprehensive Approach does not recognize the correlation that exists between securities lent and collateral received. Market values of similar, or even identical, securities lent and received as collateral are assumed to move in opposite directions in times of volatility. This is based on the flawed assumption that all securities lent have a correlation of 1.00, that all collateral received has a correlation of 1.00, and that all loans vs. collateral received have a correlation of -1.00. This results in an exposure calculation that is multiples higher than the 'maximum possible loss' a bank could sustain to a single counterparty. A specific example of the excessive risk exposures produced by the lack of offsetting benefits in the Comprehensive Approach can be found in the enclosed Annex 1 of the comment letter.

These issues are particularly pressing in non-US markets, where the use of equities and non-cash collateral in agency securities lending is common. We note, in this respect, that the Basel III liquidity framework is likely to result in the even greater use of non-cash collateral. Also, given regulatory concerns regarding collateral transformation, securities reinvestment losses and excessive reliance on wholesale funding, the proposed haircut-based methodology would create disincentives for agent lenders relative to the use of non-cash collateral that may run counter to the regulatory objectives of the Financial Stability Board ("FSB").[2]

Benefits of Securities Lending and Impact of Overstating Credit Exposures

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. Securities lending helps to increase market liquidity and enhances the overall price-discovery process by supporting various strategic and tactical asset allocation strategies. 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.

[2] 'Strengthening Oversight and Regulation of Shadow Banking', Financial Stability Board, November 18, 2012.

By dramatically overstating credit risk in securities lending activities, the Basel Committee's approach would transform the large exposure framework from a back-stop measure of risk-based capital to a binding regulatory constraint. This will, in turn, trigger a dramatic contraction of the securities lending market, with important negative implications for the financial system and the investor community. A survey conducted by the Committee on Securities Lending of the Risk Management Association in the context of the US FRB's similar methodology for the assessment of single counterparty credit concentration limits, revealed a likely decline in securities lending transactions of 30% to 50% from already significantly reduced post-financial crisis levels.[3] The impact of the Basel Committee's proposal is likely to be even more significant due to the larger number of affected banks.

Similarly, the Basel Committee's approach may actually heighten concentration risk among banks by limiting the ability of smaller institutions, including certain G-SIBs, from competing in a business that is characterized by high volumes and low margins. By requiring the use of an artificial and risk-insensitive measure of exposure to securities lending transactions, the Basel Committee will create a framework that disadvantages banks with more limited balance sheet capacity in favor of financial institutions with much larger balance sheets. As a result, securities lending activities are likely to become even more concentrated among the very largest internationally active banks.

Suggested Approach to Securities Lending

While we understand that the Basel Committee has taken the view that 'model risk should have no bearing on exposure values in a large exposures framework', we continue to believe that supervisory-approved simple VaR methodologies provide the most appropriate assessment of bank exposures to securities lending transactions. Quite simply, other existing regulatory approaches are inadequate for the measurement of credit exposures, and the use of these approaches in the large exposure regime will create market disruptions and unnecessarily harm investors. This situation is not unlike that for derivatives exposures, where the Basel Committee has conceded that the current non-model methodology for Pillar 1 risk-based capital (the Current Exposure Method, or "CEM") needs review, and is in the process of developing a more appropriate successor.

While we strongly support the use of internal models in the measurement of exposures to securities lending transactions, we note that it is possible to develop an alternative approach that provides for greater standardization and the reduced potential for model risk. State Street has presented the outlines of such an approach to the US federal banking agencies and would welcome the opportunity to do the same with the members of the Basel Committee. Under this alternative, supervisory authorities would prescribe a series of uniform inputs designed to reflect observable market data, including portfolio diversification, asset volatility and asset

[3] Committee on Securities Lending of the Risk Management Association 'Comment Letter on Issues Concerning Application of Proposed Single Counterparty Credit Limits to Agency Securities Lending and Related Transactions' (April 30, 2012); page 7.

correlation (*i.e.* the 'Supervisory Inputs Approach'). These inputs would then be used to calibrate existing supervisory-approved internal models, thereby generating exposure calculations on a consistent and readily comparable basis.

Among the benefits of the Supervisory Inputs Approach is its flexibility, including the capacity to adjust confidence levels and the ability to update parameters based upon changes in market conditions. This approach can also be designed to reflect differences in exposures resulting from 'right-way' vs. 'wrong-way' risk. Moreover, the Supervisory Inputs Approach is more fully aligned with the way that internationally active banks currently measure and manage their credit risk. Other approaches are possible, such as the use of similar supervisory inputs to construct an appropriately risk-sensitive haircut-based matrix that addresses some of the Comprehensive Approach's most pressing limitations. Any alternative should, however, be based on observable market data, should ensure sufficient risk-sensitivity and should be designed to avoid unnecessary disruptions to the securities lending market.

In view of the evident flaws in the proposed Basel II Comprehensive Approach and the need for a more detailed assessment of possible alternatives, we strongly recommend that the Basel Committee defer, on an interim basis, its decision relative to the measurement of exposures to securities lending and repurchase transactions. This would entail allowing internationally active banks to continue to make use of their existing internal models-based methodologies for the measurement of such exposures, until the completion of a through, quantitative assessment of appropriate alternatives. This recommended approach is consistent with the intended treatment of derivatives exposures, where the Basel Committee foresees the use of existing internal models methods until the adoption by the Basel Committee of a CEM successor.

LARGE EXPOSURE EXEMPTIONS

The Basel Committee notes in its Consultation the particular issues raised by the exposures that internationally active banks may have in respect of payment, clearing and settlement activities undertaken on behalf of clients, and therefore requests feedback on the feasibility of an exemption for intra-day and certain time-limited exposures. This exemption would also be designed to accommodate monetary policy operations, such as overnight exposures to banks subject to central bank reserve requirements. State Street strongly supports the introduction of targeted exemptions in the large exposure framework designed to promote the efficient functioning of global financial markets.

Intra-day and Overnight Inter-Bank Exposures

As an initial matter and in view of the Basel Committee's stated intention to align its work as closely as possible with existing regulatory capital standards, we support the full exemption of intra-day activities from the scope of the large exposure regime. This is consistent with the approach taken by the US FRB in its Notice of Proposed Rulemaking ("NPR") implementing enhanced prudential standards and early remediation requirements for systemically important

banks and designated non-banks.[4] We have no objections to the reporting of such information to appropriate national supervisory authorities, provided that such reporting is informed by a thorough cost-benefit analysis and that the reporting is aligned to the fullest extent possible with existing data sources.

In addition, we believe that there is a strong case to be made for the differentiated treatment of certain overnight inter-bank exposures. This reflects the importance of such exposures in the provision of market liquidity and the proper functioning of financial markets, as well as their dissimilar risk profile when compared with other traditional bank exposures. The overly restrictive treatment of overnight inter-bank exposures could constrain the ability of banks to lend excess reserves, or support the investment -related activities of institutional investor clients. In view of their short duration, banks are well-positioned to both monitor and control their overnight exposures to other banks. This includes the use of appropriately structured credit concentration limits, processes for addressing exception requests and the conduct of regular stress testing to identify potential vulnerabilities. Moreover, banks can and do take decisive management action to adjust their overnight inter-bank exposures as counterparty or market-wide circumstances demand. The likelihood of a default on an overnight inter-bank exposure is therefore remote and cannot reasonably be compared to the risk that banks may incur in their longer-dated liabilities.

As such, we recommend that the Basel Committee introduce within the large exposure framework an exemption for certain overnight inter-bank exposures, such as placements with banks subject to reserve requirements and *nostro* balances held with correspondent banks. Any concerns relative to the calibration of such an exemption can, in our view, be addressed via the application of standardized risk-weights found in the Basel III rules. As an example, it may be appropriate for the Basel Committee to distinguish between overnight exposures to banks in Organization for Economic Cooperation and Development ("OECD") jurisdictions where the underlying sovereign has neither defaulted or is subject to a multi-national financial assistance program, and overnight inter-bank exposures to all other banks, including those in non-OECD jurisdictions.

Payment, Clearing and Settlement Activities

Global custody banks such as State Street provide their institutional investor clients with a broad range of investment services associated with the settlement, safekeeping and administration of assets. This includes access to the global settlement infrastructure in order to complete the purchase or sale of securities. This also includes various asset servicing and cash management functions, such as the receipt of income and other interest payments, foreign currency transactions, the facilitation of client subscriptions and redemptions, and other routine transactional activities.

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[4] Board of Governors of the Federal Reserve System NPR 'Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies' (December 20, 2011).

Custody banks therefore play a central role in ensuring the timely settlement of securities transactions and the smooth operation of financial markets. This is encouraged by national supervisory authorities as a way of avoiding bottlenecks that would otherwise hamper market efficiency and exacerbate potential systemic risk. Custody banks maintain robust systems to monitor and control extensions of credit to their institutional investor clients. This includes policies and procedures adopted in accordance with national prudential regulation.

Nearly all client transactions undertaken by custody banks settle as expected and only result in intra-day exposures. Occasionally, however, a transaction may be delayed or fail due to timing, matching, systems or other similar operational impediments. Since these exposures typically arise due to unexpected matters and are generally only apparent after relevant cut-off times, it is beyond the reasonable control of custody banks to immediately eliminate or reduce these exposures. While such exposures can at times be large, they are always short-term and are effectively secured by the underlying client assets. State Street therefore believes that it is essential for the Basel Committee to include within its large exposure framework an exemption for the exposures that internationally active banks may incur when providing payment, clearing and settlement services on behalf of their clients.

There is ample precedent for regulatory flexibility in addressing the impact of transactional activities on counterparty credit exposure limits, particularly on an inter-bank basis. This includes the US FRB's Regulation F which permits, 'occasional excesses (in credit exposures) resulting from unusual market disturbances, market movements favorable to the bank, increases in activity, operational problems, or other unusual circumstances.'[5] Similarly, Regulation F specifies, among others, that 'the term credit exposure does not include exposures related to the settlement of transactions'.[6] Similarly, the European Union's ("EU") Capital Requirements Directive ("CRD") incorporates an exemption for certain day-to-day operational exposures, including in respect of foreign exchange, securities settlement and payment system activities.

Given the nature of transactional activities, it is possible that aggregate exposures to a single counterparty may exceed designated large exposure limits for a period of several days even though the initial underlying transaction causing the exposure may have cleared. This is the result of ongoing investment activities in client accounts. It is therefore essential for custody banks to have the flexibility to incur additional transactional exposures to a single counterparty when the aggregate large exposure limit has been breached, provided that adequate policies and procedures are in place to reduce the exposure in a timely manner.

More specifically, we recommend that the Basel Committee include within the large exposure framework an exemption from single counterparty concentration limits when:

[5] 12 CFR 206.3
[6] 12 CFR 206.4

- 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; and
- The bank reports the large exposure breach 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 business day period.

CENTRAL CLEARINGHOUSES

The Basel Committee proposes two alternative approaches for the treatment of bank exposures to a qualifying CCP for the purposes of the large exposure regime. The first would impose a hard cap on any such exposure, although possibly at a level higher than the general large exposure limit, to reflect the fact that financial institutions are obligated to use CCPs to clear standardized derivatives contracts. The second would exempt all bank exposures to a qualifying CCP. These exposures would, however, be subject to reporting to the relevant national supervisory authorities. All bank exposures to a non-qualifying CCP would be treated as bilateral transactions and therefore subject to general large exposure limits.

State Street strongly supports the introduction by the Basel Committee of a full exemption for bank exposures to a qualifying CCP. As an initial matter, we note that this approach best supports the broad use of CCPs in financial markets, including the commitment made by the G-20 to transition a substantial proportion of the global swaps market from over-the-counter ("OTC") bilateral transactions to a standardized, centrally-cleared model. Moreover, we believe that this alternative will help mitigate potential market fragmentation, enhance operational efficiencies and reduce investor costs.

CCPs are subject to authorization and ongoing risk-based supervision by relevant national supervisory authorities. In the case of the US, systemically important CCPs operate under the consolidated supervision of the FRB. CCPs are tasked with reducing risk in financial markets by substituting the performance of the CCP for that of the original counterparties to a transaction, and by centralizing the management of credit risk. As an example, the Fixed Income Clearing Corporation, a subsidiary of the Depositary Trust and Clearing Corporation, is the preferred method for transacting repurchase and reverse repurchase agreements in US Treasury and US Agency securities due to the transparency of the clearing process, the availability of real time data and the protections afforded to its participants in the event of a counterparty default.

CCPs are subject within their respective national jurisdictions to both conduct of business and organizational requirements. In order to be deemed a qualified CCP, these requirements must be consistent with the standards prescribed by the Committee on Payment and Settlement Systems – International Organization of Securities Commissions for FMIs. This includes the presence of a sound legal basis, strong governance standards, appropriate credit and liquidity risk management systems and adherence to transparency obligations. In addition, CCPs are subject to measures designed to control their operational risk, such as initial and variation margin, asset segregation and portability requirements. Market risk is addressed, in turn, through the provision of various services such as real-time trade matching, netting and settlement, as well as participant default fund contributions.

Most counterparties, including end-users and buy-side investors, will not be in a position to become a direct CCP member and must therefore rely on bank intermediaries to facilitate the clearing of their transactions. This is especially true in the case of the OTC derivatives markets. It is therefore essential that internationally active banks be provided with the proper incentives and means to provide their clients with access to centralized clearing. In our view, a full exemption for bank exposures to qualifying CCPs would help achieve this goal.

COLLECTIVE INVESTMENT UNDERTAKINGS AND SECURITIZED ASSETS

The Basel Committee proposes to require internationally active banks when investing in collective investment undertakings, including securitizations and other similar entities (collectively "CIU"), to implement a look-through approach designed to identify and aggregate the underlying exposures in each CIU for the purposes of assessing single name counterparty concentration risk, unless each of the underlying exposures in the CIU represents less than 1% of total scheme assets. This is referred to as the 'granularity test'. If a bank cannot look through to the underlying assets in a CIU, it will be required to aggregate all unidentified exposures into a generic 'unknown client' bucket. Total exposure to the 'unknown client' cannot exceed the generally applicable large exposure limit. Furthermore, the Basel Committee proposes that internationally active banks be required to check, on a case-by-case basis, for 'additional risks' in CIU, such as common exposure to a fund manager or credit protection provider, and to aggregate such exposures if a common risk factor is identified.

Collective Investment Undertakings

State Street is concerned that the Basel Committee's intended framework is overly complex and is unlikely to capture exposures that are material in respect of either insolvency or systemic risk. We note, in this respect, that the proposed granularity test is so stringent that it will likely fail to exclude exposures to broad-based market indices, such as the S&P 500 and the Barclays Capital US Aggregate Bond Index. More broadly, we believe that it is more appropriate for the large exposure framework to focus on whether an exposure to a CIU is material relative to the bank's total regulatory capital, rather than on whether the underlying assets are material relative to the CIU.

The ‘additional risk’ component of the intended framework is particularly problematic since it is highly subjective and yet carries the potential for punitive treatment. We are not convinced, in this respect, of the appropriateness of the Basel Committee’s description of ‘additional risk’ as including the potential for fraud on the part of a fund manager with investment discretion over one or more CIU. As an initial matter, we note that fraud and other similar acts of malfeasance are treated under the Basel II risk-based capital framework as operational risk as opposed to credit risk, and are subject to a Pillar 2 capital charge.

Furthermore, we emphasize that most CIUs have a separate legal existence and that it is therefore not possible to routinely comingle or to otherwise mix the assets of different underlying funds. Similarly, fund managers do not generally hold direct custody of CIU assets, relying instead on a separate custodial entity to perform safekeeping and asset servicing functions. This is often required by national law or regulation. As an example, the EU UCITS Directive prescribes the use of a depositary with specific safekeeping and oversight responsibilities over fund assets. This is also true of the Alternative Investment Fund Manager Directive, which governs all non-UCITS funds in the EU as of July 2013.

Similarly, the Investment Company Act of 1940 governs the client asset protection requirements that apply to US mutual funds. Investment advisers in the US are, in turn, subject to the ‘custody rule’ of Section 206(4)-2 of the Investment Advisers Act of 1940, which specifies that ‘It is a fraudulent, deceptive, or manipulative act…to have custody of client securities unless (the investment adviser) is as qualified custodian’.[7] Although safekeeping and asset servicing may be undertaken by an entity with a separate legal existence, it may also be undertaken by prudentially-regulated entities that are functionally separate from the fund manager.

We therefore believe that the Basel Committee should limit its description of ‘additional risk’ in CIUs to matters that may represent further sources of credit risk rather than operational risk. Moreover, the Basel Committee should specifically acknowledge that potential fraud by a fund manager can effectively be addressed via the presence of either the legal or the functional separation of the asset management and safekeeping functions.

In addition, State Street recommends a series of adjustments to improve the calibration and reduce the operational burden of the look through and ‘additional risk’ aggregation requirements. First, we recommend that the Basel Committee introduce within the large exposure framework an exemption for the investments made by banks in regulated CIS, such as US mutual funds, EU UCITS and their foreign equivalents. These investment entities already meet detailed transparency, asset quality and asset diversification requirements that limit the potential for unanticipated concentration risk. They are also subject to ongoing, comprehensive regulatory oversight.

[7] 17 CFR 275.206(4) - 2

Second, we recommend that the Basel Committee adjust the granularity test for CIUs by raising the applicable threshold for the look-through and 'additional risk' aggregation requirement from 1% to 5% of total scheme assets. Alternatively, the Basel Committee way wish to consider the introduction of a dual test designed to better reflect instances of material concentration risk. Under this dual test approach, internationally active banks would be required to conduct the prescribed look through and 'additional risk' assessment of the large exposure regime for any investment in a CIU representing more than 1% of regulatory capital, unless the CIU meets the Basel Committee's proposed 1% granularity test.

Treatment of Securitized Assets

While our analysis of the Basel Consultation is based on a 'plain reading' understanding of key terminology, we note that there is considerable uncertainty within the banking industry regarding the intended definition of the term 'investment' and the term 'securitization'. This is reflected, among others, in the joint NPR issued by the US federal banking agencies in June 2012 to revise and replace capital rules for US banks.[8] Under the proposed US NPRs, bank exposures to investment funds not otherwise excluded by rule, namely US pension plans, US mutual funds and their foreign equivalents, would be deemed potential securitizations. As securitizations, these exposures would be subject to risk-based capital requirements that differ significantly from those that traditionally apply to investment fund exposures.

This could potentially extend to certain well-established banking services, such as extensions of credit provided by custodian banks in support of their client's day-to-day investment-related activities, which bear little if any resemblance to the traditional understanding of a securitization. In our view, it would be inappropriate for a similarly expansive definition of the term 'securitization' and the term 'investment' to be used in the context of the Basel Committee's large exposure regime to compel banks to apply the intended look-through and 'additional risk' aggregation requirements to their investment fund exposures.

More generally, we are also concerned that the Basel Committee's approach may not properly reflect the particular features of traditional securitizations and may therefore require the inappropriate assessment of concentration risk. As an example, it is not clear to us how to meaningfully aggregate assets in a securitization structure for the purposes of assessing large exposure limits, in view of the existence of varying credit tranches and varying credit enhancement features. Furthermore, we question the appropriateness of the suggestion that the originator of a traditional securitization may represent an additional source of concentration risk, in view of their status as non-recourse obligations.

State Street therefore recommends that the Basel Committee more clearly specify the scope of the look through and 'additional risk' aggregation requirements for traditional securitizations,

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[8] Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation and Board of Governors of the Federal Reserve System NPRs; (i) 'Regulatory Capital Implementation of Basel III', (ii) 'Standardized Approach for Risk-Weighted Assets' and (iii) 'Advanced Approaches Risk-Based Capital Rule' (June 7, 2012).

including confirmation that the term 'securitization' is not meant to encompass routine extensions of credit that internationally active bank's may provide to investment fund clients in support of day-to-day investment-related activities. Similarly, it may be appropriate for the Basel Committee to consider the introduction of a limited exemption encompassing the most senior tranches of a traditional securitization, provided that these instruments meet certain prescribed investment grade criteria.

LARGE EXPOSURE REQUIREMENTS FOR G-SIBs

The Basel Committee proposes the introduction of a narrower 10% to 15% large exposure limit for banks that have been identified by the FSB as systemically important (*i.e.* G-SIBs). This is ostensibly designed to further reduce the possibility of contagion among banks that are likely to have the greatest systemic impact in the event of insolvency. Under the intended framework, national supervisory authorities retain the ability to impose more stringent limits and to extend the framework to other financial institutions, including domestic systemically important banks.

As an initial matter, we re-emphasize our view that the Basel large exposure framework should not be used a basis for addressing all potential vulnerabilities in financial markets. We note, in this respect, that the risk posed by interconnectedness within the financial industry is already being addressed via a number of regulatory reform initiatives. This includes the heightened capital and liquidity requirements of the Basel III Accord, the G-SIB capital surcharge, reform of OTC derivatives markets and new global standards for recovery and resolution planning. This also includes the enhanced prudential standards and early remediation requirements of Section 165/166 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, which apply to US banks with more than $50 billion in consolidated assets, as well as any non-bank designated for supervision by the FRB.

Notwithstanding their common designation, G-SIBs are not uniform in terms of size and scope, running the spectrum from mega banks with total assets well in excess of $2.5 trillion, to State Street with total assets of $220 billion. State Street is ranked 90th in the world by total assets, on par with many domestic banks and significantly below the rank of any of its G-SIB peers.[9] Also, while most G-SIBs are universal banks with extensive commercial, investment banking and capital markets operations, the list includes two global custodians with very different business models.

Global custody banks specialize in the provision of high-volume, low-risk financial services to the institutional investor community. They therefore tend to be disproportionately impacted by risk-insensitive measures, such as the Basel Committee's proposed large exposure regime. As such, a more restrictive large exposure limit for all G-SIBs may inadvertently frustrate one of the Basel Committee's underlying goals, which is the efficient operation of global financial markets. Indeed, the challenges presented by payment, clearing and settlement activities are

[9] 'Top 150 Banks Worldwide Ranked by Asset Size', The Banker, July 2012.

likely to be even more pronounced if certain global custody banks are required to operate on the basis of a narrower 10% to 15% concentration limit.

We therefore strongly oppose the introduction by the Basel Committee of a separate large exposure limit based solely upon designation as a G-SIB. Instead, the Basel Committee may wish to specify that each national jurisdiction must introduce its own threshold for systemically important financial institutions, based upon the structure of its local financial system, the varying risk profile of its banks and the presence of different business models.

If the Basel Committee remains convinced of the need for a separate large exposure approach for all G-SIBs, we recommend that it consider the introduction of a more granular solution in which G-SIBs are grouped into different large exposure buckets based upon their particular risk profile. Consistent with the indicator-based methodology developed by the Basel Committee to determine systemic importance for the purposes of the G-SIB capital surcharge, this would include an assessment of the scope of cross-jurisdictional activities, balance sheet size and composition, financial interconnectedness, organizational and financial complexity and substitutability. Structurally, we suggest that the Basel Committee introduce an initial 'empty' large exposure bucket of 15% designed to serve as a disincentive for banks to become more systemically important, followed by four additional large exposure buckets set at 17.5%, 20.0%, 22.5% and 25.0% of regulatory capital.

OTHER METHODOLOGICAL CONCERNS

Connected Counterparties

The Basel Committee introduces within its large exposure framework the concept of connected counterparties, defined on the basis of both a relationship of control and economic interdependence. Under this approach, internationally active banks would need to consider and aggregate both types of exposures when assessing single name concentration risk.

As an initial matter, we welcome the Basel Committee's decision to define a relationship of control on the basis of whether a bank owns more than 50% of the voting rights of a given entity. This bright-line test should significantly reduce the complexity that internationally active banks would otherwise face in trying to collect and aggregate information on a broad range of entities that may not be publicly or readily available. Still, we are troubled by the parallel requirement that banks must seek to determine other instances of common control, as well as the requirement to assess possible economic interdependence among counterparties.

Notwithstanding the qualitative criteria specified by the Basel Committee, this remains a deeply subjective process open to varying interpretation and different outcomes. Moreover, this requirement will necessitate significant expenditures by banks and yet is unlikely to prove helpful in identifying material instances of concentration risk. This can be seen in the financial industry's experience with the treatment of connected counterparties in the EU large exposure

regime, which is broadly described as a highly manual and cost ineffective exercise, with little to no risk mitigation benefits.

We therefore urge the Basel Committee to amend its large exposure framework so that internationally active banks are only required to measure their single name counterparty exposures on the basis of entities that are consolidated for financial reporting purposes. This would allow banks to rely on consistent, verifiable and continuously available sources of data to ensure their compliance, rather than on the basis of other, less objective criteria. As a prudential matter, the Basel Committee may also wish to introduce the general principle that internationally active banks must endeavor to identify and aggregate counterparty exposures for purposes of assessing single name concentration risk where there is a reasonable expectation of control or economic interdependence.

Financial Collateral

The Basel Committee proposes to require internationally active banks, when making use of financial collateral to mitigate their credit exposures, to apply a novel 'hybrid' approach which combines elements of the Basel II haircut-based and substitution methodologies. Under this alternative, financial collateral would be subject to both a series of standardized supervisory haircuts and 'collateral substitution', involving the mandatory transfer of the risk exposure to the issuer of the collateral.

As an initial matter, we note that this approach represents a significant departure from prevailing industry and regulatory practice. It is therefore likely to require major investments by internationally active banks in new data systems and operational processes. Moreover, it is not clear to us that sufficient attention has been paid to the limitations of the intended approach. More specifically, we are concerned that the proposed 'hybrid approach' fails to reflect the substantial unlikelihood of a double default impacting both the initial exposure and the underlying collateral. Indeed, the Basel Committee's approach makes no distinction between direct and indirect exposures, and therefore makes the implausible assumption that a bank will face the simultaneous default of both the initial exposure and the underlying collateral.

While this effect will vary depending upon the correlation that exists between the exposure and the collateral, as well as the number and nature of the of underlying counterparties, by failing to address differences in the probability of default in indirect exposures, the Basel Committee's approach will result in the significant overstatement of concentration risk. Although we acknowledge possible concerns relative to the indirect exposures that may exist among G-SIBs, we believe that it would be inappropriate to treat all indirect exposures in the same manner, such as those that an internationally active bank may have to non-banks. Moreover, we note that collateral substitution could have the perverse effect of increasing systemic risk by discouraging the prudent use of collateral hedges and by encouraging the migration of financial transactions away from prudentially-regulated banks to less regulated shadow banking entities.

State Street therefore recommends that the Basel Committee forego the introduction of the 'hybrid approach' in the context of financial collateral and allow internationally active banks to continue to rely on existing risk-based capital methodologies. Alternatively, we recommend that the Basel Committee consider the introduction of a standardized distribution-based matrix designed to more accurately reflect the credit risk of indirect exposures. Such a matrix could be set at a high-level of confidence and could also be adjusted to reflect different liquidation time horizons. At a minimum, we strongly urge the Basel Committee to introduce an approach to financial collateral that distinguishes between the exposures of an internationally active bank to a G-SIB, to any other bank and to a non-bank.

State Street has begun the process of assessing the possible design of a standardized distribution-based matrix and we would welcome the opportunity to share our findings with the Basel Committee. While we view the intended haircut-based approach as suboptimal in the assessment of exposures to securities lending transactions, the use of a properly designed standardized distribution-based matrix would at least serve to mitigate the otherwise disproportionate impact of double default in the assessment of a bank's single name concentration risk**.**

Credit Conversion Factor

The Basel Committee proposes to incorporate, within the large exposure framework, a CCF of 100% for the traditional off-balance sheet obligations of internationally active banks. The only exception is in the case of trade finance, based upon the Basel Committee's view that a 100% CCF for such activities could have material unintended consequences. We believe that there are other low-risk contingent obligations that play an essential role in the promotion of financial market stability that should also benefit from more proportionate treatment under the large exposure regime. Specifically, as a global custody bank, we urge the Basel Committee to introduce a more granular CCF for committed lines of funding provided to regulated CIS. This includes US mutual funds, EU UCITS and other similar foreign equivalents.

Regulated CIS are structured for sale to the retail investor community and are governed by detailed transparency, asset quality and diversification requirements. They must adhere to specific limits on both borrowed funds and leverage. As an example, US mutual funds are not permitted to incur indebtedness unless the fund maintains an asset coverage ratio, including borrowed funds, of at least 300%. Similarly, retail UCITS are prohibited from borrowing more than 10% of the value of the fund's net assets. For other types of UCITS, limits are set by the fund's investment profile, but generally do not exceed 25% to 40%.

Regulated CIS therefore have limited and well-defined credit needs. They are also subject to ongoing regulatory supervision. Custody banks provide committed facilities to regulated CIS on contractual terms to accommodate routine day-to-day operational matters. This includes unanticipated movements of cash, client redemption activities and the payment of management fees and other expenses. Committed facilities to regulated CIS are therefore important for the efficient operation of financial markets. If custody banks were subject to

significant restrictions in their ability to offer such facilities to regulated CIS, this would necessitate special processes that would heighten potential transaction risk, increase investor costs and disrupt market efficiencies.

Committed facilities to regulated CIS have features that carefully limit their tenor and usage, including asset quality and diversification minimums and short repayment obligations (typically 30-60 days). Although money market funds ("MMF") may have access to committed facilities as part of a contractual agreement with the sponsor of a fund family, our experience is that MMFs rarely make use of such commitments due to the composition of their assets and the nature of their investment mandate. In addition, committed facilities to regulated CIS are either secured by the fund's assets or are otherwise subject to de facto collateralization via a lien or other similar legal arrangement. As such, our experience is that committed facilities provided to regulated CIS represent limited credit risk and are unlikely to experience significant draw-downs, even during periods of financial market stress.

This is reflected in an assessment of US mutual fund utilization rates at State Street during the financial crisis, which revealed incremental drawn-down rates below 10%. This information has previously been provided to the Basel Committee in the context of the Basel III Liquidity Accord and is reflected in the use of different draw-down rates for various committed facilities to financial and non-financial institutions in the context of the Liquidity Coverage Ratio.[10] We therefore recommend that the Basel Committee amend its approach by incorporating a more granular CCF of 20% for committed facilities to regulated CIS. This is consistent with the proposed treatment of short-term trade finance, as well as the lowest CCF risk-weight factor under the Basel II Standardized Approach.

CONCLUSION

Thank you once again for the opportunity to comment on the important matters raised within this Consultation. To summarize, while we support the development of a uniform framework for the assessment of large exposures by internationally active banks, we believe that such a framework must be appropriately risk-sensitive and should reflect, to the greatest extent possible, existing methodologies for the measurement of regulatory capital. We also believe that the Basel Committee's large exposure framework should not attempt to address all potential vulnerabilities in financial markets.

We are disappointed by the Basel Committee's decision to exclude from the large exposure framework the use by internationally active banks of supervisory-approved internal models since this is likely to result in the significant overstatement of concentration risk. We note the potential for the large exposure framework to constrain the ability of custody banks to provide well-established services to their institutional investor clients.

[10] Basel III: The Liquidity Coverage Ratio and Liquidity Risk Monitoring Tools (January 2013); Section 131.

State Street therefore recommends a series of targeted modifications to the intended framework. This includes the ability of internationally active banks to continue to rely on appropriately risk-sensitive methodologies for the measurement of exposures to securities lending transactions, the introduction of a time-limited carve out for exposures resulting from payment, clearing and settlement activities undertaken on behalf of clients, and the full exemption of bank exposures to qualifying CCPs.

We also recommend that the Basel Committee adjust the threshold for the look through and 'additional risks' aggregation requirement for investments in CIU, and also the removal or the significant recalibration of the intended large exposure limit for G-SIBs. Finally, we recommend that internationally active banks only be required to measure their exposures to connected counterparties on the basis of consolidated financial reporting, that the large exposure framework properly address the substantial improbability of a 'double default' in its treatment of financial collateral, and the introduction of a more granular CCF for committed lines of funding to regulated CIS.

Please feel free to contact me at smgavell@statestreet.com should you wish to discuss State Street's submission in greater detail.

Sincerely,

Stefan M. Gavell

ANNEX 1

Example of the Impact of the Comprehensive Approach on the Measurement of Securities Lending Exposures

The risk of an individual security can be viewed, at a high-level, as a combination of an idiosyncratic risk component, plus a market risk component ($\alpha + \beta m$).

The combined risk of a security lent and a security received as collateral would therefore be ($\alpha 1 + \beta 1m$) – ($\alpha 2+\beta 2m$), which equals the square root of (($\alpha 1$)2+($-\alpha 2$)2+2($\alpha 1$)($- \alpha 2$)(ρ))+($\beta 1-\beta 2$)m).

Taking conservative market-based assumptions the risk of such a combination would then be the square root of ((2.12)+(-3.22)*2(2.1)(-3.2)(-1.00))+ ((.8-.7)*10.6) = ***6.36.***

The market-based assumptions are:

$\alpha 1$ = 2.1%
$\alpha 2$ = 3.2%
ρ = -1.00 (this is a most conservative estimate, thereby providing a worst case outcome)
$\beta 1$ = .8
$\beta 2$ = .7
m = 10.6%

The proposed haircut-based methodology does not recognize the offsetting benefit of the βs and effectively adds them together, thereby deriving a significantly higher risk of the combined position (10.61+10.61) = ***21.22.***