April 11, 2014

BY ELECTRONIC SUBMISSION

Basel Committee on Banking Supervision
Bank of International Settlements
SH-4002 Basel
Switzerland

Re: **Consultative Document, Basel III: The Net Stable Funding Ratio**

Ladies and Gentlemen:

The Bank of New York Mellon Corporation, Northern Trust Corporation, and State Street Corporation (collectively, the "**Custody Banks**") appreciate the opportunity to comment on the Consultative Document, *Basel III: The Net Stable Funding Ratio* (the "**NSFR**"), issued by the Basel Committee on Banking Supervision ("**Basel Committee**").[1] The Custody Banks understand that the NSFR is intended to limit overreliance on short-term wholesale funding and to encourage more stable funding profiles.[2]

The Custody Banks support the Basel Committee's continued efforts to strengthen the resiliency of the banking sector globally by requiring banks to maintain stable funding in relation to their on-balance sheet assets and off-balance sheet activities under normal, business-as-usual conditions over a one-year horizon. The recognition of operational deposits as a source of available stable funding ("**ASF**") in the NSFR is a welcome step toward this goal. We believe, however, that the proposed 50 percent ASF factor for operational deposits is far too low in a structural measure of liquidity, and therefore substantially understates the inherent stability of custody and other operational deposits. A 75 percent ASF factor more accurately reflects industry experience, while nonetheless remaining appropriately conservative.

We understand from conversations in industry forums that the use of a 50 percent ASF factor for operational deposits in the NSFR reflects two primary concerns: (A) the robustness of the current operational deposit classification criteria, and (B) withdrawal behavior over the one-year NSFR horizon. The remainder of this letter responds to these concerns.

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[1] Basel Committee on Banking Supervision, Consultative Document, *Basel III: The Net Stable Funding Ratio* (Jan. 2014).

[2] *Id.* at ¶ 1.

A. Criteria for Operational Deposits

The Basel III Liquidity Coverage Ratio ("**Basel III LCR**") first established the criteria for operational deposits generated by clearing, custody, and cash management activities.[3] The Basel Committee notes in the Consultative Document that, for purposes of the NSFR, the definition of "operational deposits" will be the same as that in the Basel III LCR.[4] Still, we understand that the Basel Committee has concerns regarding the divergent classification of operational deposits among national jurisdictions. These differences appear to arise from national implementation of the Basel III LCR, where certain approaches may be insufficiently rigorous to capture only those operational deposits that are highly stable.

In recognition of these concerns, the Custody Banks propose a uniform set of criteria to classify operational deposits in the Basel Committee's quantitative liquidity framework. These criteria are intended to provide an appropriate structure for the treatment of operational deposits that addresses the Basel Committee's concerns and to ensure proper recognition of this crucial, stable funding source. These criteria are derived from the approach of the United States bank regulatory agencies,[5] with certain technical adjustments, to better reflect the Basel Committee standard and the profile of core, stable deposits that are a by-product of operational services. These definitions and criteria are attached in Appendix 1.

Furthermore, we emphasize that supervisors will have broad discretion to review a bank's categorization of operational deposits and to take additional measures as appropriate. As the Consultative Document states, "the NSFR must be supplemented by supervisory assessment work" as "a key component of the supervisory approach to funding risk."[6] Thus, to the extent supervisors have additional concerns about banks placing non-stable sources of funding in the operational deposit category, those concerns can be further addressed by supervisory means.[7]

B. ASF Factor for Operational Deposits

Operational deposits provide a stable, predictable source of funding during normal and stressed financial market conditions. Historically, the Custody Banks have experienced very low outflow rates for operational deposits. In this regard, we welcomed the Basel Committee's adoption of a 25 percent outflow rate for operational deposits in the Basel III LCR to recognize this stable deposit profile. The 25 percent outflow rate remains a conservative estimate of the run-off behavior of operational deposits and should be adopted in the NSFR. The proposed 50 percent ASF factor in the NSFR, by contrast, is wholly inconsistent with the historical experience of the Custody Banks.

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[3] Basel Committee on Banking Supervision, *Basel III: The Liquidity Coverage Ratio and Liquidity Risk Monitoring* Tools ¶¶ 93-103 (Jan. 2013).

[4] Basel III NSFR, at ¶ 21(b).

[5] Liquidity Coverage Ratio: Liquidity Risk Measurement, Standards, and Monitoring; Proposed Rule, 78 Fed. Reg. 71818, 71858-60 (Nov. 29, 2013).

[6] Basel III NSFR, at ¶ 10.

[7] *See also* Basel III LCR, at ¶ 93 ("Supervisory approval would have to be given to ensure that banks utilizing this treatment actually are conducting these operational activities at the level indicated.").

Operational deposits derive from core operational services, such as custody and asset administration, which are provided to clients pursuant to legally binding written agreements. Our operational deposit balances remain very stable because clients need to maintain a base of funds to make payments and conduct other transactional activities on a day-to-day basis. Although the Custody Banks do lose clients, change is incremental rather than sudden because of the time, resources, and effort involved in establishing a new servicing relationship. Moreover, servicing changes occur with advance notice and take several months to complete, giving a bank sufficient time to manage the associated liquidity and funding risk. Operational service agreements generally specify minimum notification periods of 30 days or more to terminate a contract, and transitional periods can extend to one year or more.

Given this experience, it is surprising that the NSFR—a normal, business-as-usual measure—estimates a 50 percent outflow rate that is even *more* conservative than the LCR. Unlike other liabilities, operational deposits are subject to detailed requirements which have grown progressively more stringent over time. This can be seen in the expansive list of qualifying criteria specified in the Basel III LCR spanning eleven paragraphs. In addition, banks must both identify and exclude “excess balances” from the operational deposit category. As a result, the current treatment of operational deposits leads to a category of funding that is extremely stable, whether assessed over a period of short term financial market stress, or over the longer term NSFR horizon.

Given this stable funding profile, the Custody Banks believe that a 75 percent ASF factor is an appropriate—yet still conservative—measure of the outflow behavior of operational deposits under normal, business-as-usual conditions.

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The Custody Banks appreciate this opportunity to comment on the Basel Committee’s critical work to strengthen the resiliency of the global banking system by encouraging stable sources of funding. We believe that operational deposits, notably custody deposits, are a core source of stable funding and should be recognized as such. We would be happy to discuss any of these issues further. Should you have any questions or need any additional information, please contact Eli Peterson, Managing Director, The Bank of New York Mellon Corporation, at (202) 624-7925 or eli.peterson@bnymellon.com; David Charney, Senior Vice President, Northern Trust Corporation, at (312) 444-4782 or dhc1@ntrs.com; or Rob McKeon, Vice President, State Street Corporation, at (617) 664-7632 or ramckeon@statestreet.com.

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Appendix 1

The Custody Banks propose the following definitions and criteria to identify operational deposits in the context of the Basel Committee's quantitative liquidity framework. These recommendations are adapted from the Basel III LCR and the U.S. bank regulatory agencies' proposed implementation of the LCR.

Operational Deposits

Operational Deposits mean unsecured wholesale funding that is necessary for a bank to provide operational services as an independent third-party intermediary, agent, or administrator to the wholesale customer or counterparty providing the unsecured wholesale funding.[8]

In order to recognize a deposit as an operational deposit, the following conditions must be met:

(1) The operational services to which the deposit relates are provided pursuant to a legally binding written agreement, the termination of which is subject to a minimum 30-day notice period or significant switching costs to be borne by the customer;[9]

(2) The deposit must be a by-product of the underlying services provided by the bank and must not be sought out in the wholesale market in the sole interest of offering interest income;[10]

(3) The deposit must be held in an account identified as an operational account;[11]

(4) The customer must hold the deposit at the bank for the primary purpose of obtaining the operational services provided by the bank;[12]

(5) The deposit account must not be designed to create an economic incentive for the customer to maintain excess funds therein through increased revenue, reduction in fees, or other offered economic incentives;[13]

(6) The bank must demonstrate that the deposit is empirically linked to the operational services and that it has a methodology for identifying any excess amount, which must be excluded from the operational deposit amount and which must be conducted at a sufficiently granular level to adequately assess the risk of withdrawal of excess balance;[14]

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8 *See* 78 Fed. Reg. 71818, 71858 (definition of "operational deposit"); Basel III LCR, at ¶ 94.

9 *See* 78 Fed. Reg. 71818, 71859 (proposed § __.4(b)(1)); Basel III LCR, at ¶ 94.

10 *See* Basel III LCR, at ¶¶ 94, 95.

11 *See* 78 Fed. Reg. 71818, 71859 (proposed § __.4(b)(3)); Basel III LCR, at ¶ 95.

12 *See* 78 Fed. Reg. 71818, 71859 (proposed § __.4(b)(4)).

13 *See* 78 Fed. Reg. 71818, 71859 (proposed § __.4(b)(5)); Basel III LCR, at ¶ 95.

14 *See* 78 Fed. Reg. 71818, 71859 (proposed § __.4(b)(6)); Basel III LCR, at ¶¶ 96-97.

(7) The deposit must not be provided in connection with the bank's provision of prime brokerage services; prime brokerage services are defined as a package of services offered by a bank under a contractual arrangement whereby the bank, among other services, clears, settles, carries, and finances transactions entered into by the client with the bank or a third-party entity (such as an executing broker), and where the bank has a right to use assets provided by the client, including in connection with the extension of margin and other similar financing of the client, subject to applicable law;[15] and

(8) The deposit must not arise out of a correspondent banking arrangement in which one bank (correspondent) holds excess amounts owned by other banks (respondents) in connection with payment and other services in order to settle foreign currency transactions (e.g., nostro and vostro accounts used to settle transactions in a currency other than the domestic currency of the respondent bank for the provision of clearing and settlement of payments).[16]

[15] *See* Basel III LCR, at ¶ 99 & n. 42; Financial Conduct Authority & Prudential Regulatory Authority Handbook, Glossary (April 2013) (definition of "prime brokerage services"), *available at* http://www.fshandbook.info/FS/html/handbook/; Letter from Brandon Becker, Director of the Division of Market Regulation, Securities and Exchange Commission, to Jeffrey C. Bernstein, Prime Broker Committee, at 2 (Jan. 25, 1994), *available at* http://www.sec.gov/divisions/marketreg/mr-noaction/pbroker012594-out.pdf.

[16] *See* 78 Fed. Reg. 71818, 71859 (proposed § __.4(b)(8)); Basel III LCR, at ¶ 99 & n. 42.

Operational Services

Operational services means the following services, provided they are performed as part of cash management, clearing, or custody services:[17]

(1) Payment remittance and debt service payments;

(2) Payroll administration and control over the disbursement of funds;

(3) Transmission, reconciliation, and confirmation of payment orders;

(4) Daylight overdraft;

(5) Determination of intra-day and final settlement positions;

(6) Settlement of securities transactions and foreign currency transactions;

(7) Transfer of recurring contractual payments;

(8) Client subscriptions and redemptions;

(9) Scheduled distribution of client funds;

(10) Escrow, funds transfer, stock transfer, trustee and agency services, including payment and settlement services, payment of fees, taxes, and other expenses; and

(11) Collection and aggregation of funds;

(12) Administration of investment assets;

(13) Collateral management services; and

(14) Corporate trust services.

[17] *See generally* 78 Fed. Reg. 71818, 71858 (definition of "operational service"); Basel III LCR, at ¶¶ 101-03.