Stefan M. Gavell
Executive Vice President and Head of
Regulatory, Industry and Government Affairs

State Street Corporation
State Street Financial Center
One Lincoln Street
Boston, MA 02111-2900

Telephone: 617.664.8673
Facsimile: 617.664.9339
smgavell@statestreet.com

April 11, 2014

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

Via electronic submission: www.bis.org/bcbs/commentupload.htm

Consultative Document – Basel III: The Net Stable Funding Ratio

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 Net Stable Funding Ratio ("NSFR"). The NSFR forms part of the Basel III Accord, and is one of two minimum liquidity standards prescribed by the Basel Committee for internationally active banks ("covered banks"). First proposed in December 2009, the NSFR has been substantially revised from a stressed measure of liquidity to a structural measure of liquidity over a one-year horizon. The NSFR is intended to limit overreliance by covered banks on sources of short-term wholesale funding, encourage the more thorough assessment of liquidity risk and promote greater stability in funding profiles. It is the Basel Committee's intention to introduce the NSFR as a binding minimum standard for covered banks, effective January 1, 2018.

Headquartered in Boston, Massachusetts, State Street specializes in providing institutional investors with investment servicing, investment management and investment research and trading. With $27.43 trillion in assets under custody and administration and $2.35 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

[1] As of December 31, 2013.

company, with operations conducted through several entities, primarily its wholly-owned bank subsidiary, State Street Bank and Trust Company.

Our perspective in respect of the Consultation reflects our status as an internationally active bank subject to the Basel III Accord, as well as our status as one of the world's largest providers of global custody services. As a custody bank, we specialize in serving the investment needs of institutional investor clients and maintain an extensive network of direct and indirect links with financial market infrastructure, in order to facilitate the day-to-day management of investment assets. These clients include asset owners, asset managers and official institutions, and encompass US mutual funds and other similar foreign equivalents; corporate and public retirement plans; sovereign wealth funds; central banks; alternative investment funds; insurance company general and separate accounts; charitable foundations and endowments.

We appreciate the opportunity to offer insight relative to the impact of the Consultation on our role as a custodial entity, a role that is widely understood by the market and by the supervisory community as providing important benefits for the safety of client assets and the stability of the financial system. Under a well-calibrated measure of structural liquidity, our conservative business model and deposit funded balance sheet should result in a robust NSFR, with high-levels of resilience to possible liquidity shocks.

INTRODUCTORY COMMENTS

State Street welcomes the efforts of the Basel Committee to strengthen the funding profile of covered banks by limiting excessive reliance on sources of unstable funding and therefore the potential emergence of systemic instability. This includes the standards prescribed by the Basel Committee in its 'Principles for Sound Liquidity Risk Management and Supervision', which have been guiding industry and regulatory practice since 2008. This also includes the introduction of two minimum quantitative liquidity standards: the Liquidity Coverage Ratio ("LCR") designed to address instances of acute short-term financial market stress, and the longer-term NSFR. We have been actively engaged in the development of liquidity regulation since the release of the Basel III Accord in late 2009. In April 2010, we submitted a comment letter to the Basel Committee on the initial design and calibration of the LCR and NSFR[2], and more recently, we submitted comments to the US federal banking agencies on national implementation of the LCR.[3]

In our view, there are three considerations that should inform the design of the NSFR. First, we believe that continuing efforts should be made to ensure that the NSFR fully and comprehensively reflects the varying business models of banks subject to the Basel III Accord.

---

[2] Basel Committee on Banking Supervision – Consultative Document: International Framework for Liquidity Risk Measurement, Standards and Monitoring (December 17, 2009).

[3] Board of Governors of the Federal Reserve, Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation – Joint Notice of Proposed Rulemaking: Liquidity Coverage Ratio: Liquidity Risk Measurement, Standards and Monitoring (October 24, 2013).

Global custody banks, such as State Street, are uniquely focused on serving the investment needs of institutional investor clients. This centers on the provision of a broad range of financial services associated with the safekeeping and administration of investment assets, including the processing of income and other interest payments, tax reclamations, foreign currency transactions, the facilitation of client subscriptions and redemptions and other day-to-day transactional matters. Custody banks also provide access to the global settlement infrastructure in order to complete the purchase or sale of investment securities. Indeed, the strong operational dependencies of the custody bank business model is one of the primary factors that led the Basel Committee to incorporate within the LCR a specific outflow rate for operational deposits as distinct from wholesale funding generally.

While we believe that the Basel Committee has made progress in recognizing the custody bank business model, we are concerned that the NSFR continues to reflect important misunderstandings regarding the characteristics and behavior of custody deposits. Specifically, we believe that the intended 50% available stable funding factor ("ASF") substantially understates the inherent stability of custody deposits, as demonstrated by industry experience since the financial crisis.

Second, we believe that particular care must be taken in ensuring the proper calibration of the NSFR as a structural measure of liquidity. This includes a data driven assessment of the several criteria that define required stable funding ("RSF") and ASF, which the Basel Committee acknowledges represent 'parameters intended to approximate' the presumed degree of stability of liabilities and the liquidity of assets.[4] While we appreciate the considerable efforts of the Basel Committee in redefining the scope of the NSFR, we believe that additional attention should be paid to the differences between a stressed and a structural measure of long-term liquidity. This includes the extent of reliance on parameters derived from the short-term LCR. In this respect, we strongly welcome the Basel Committee's decision to continue to monitor the design of the NSFR throughout the observation period, and to make adjustments as circumstances require.

We believe that particular attention must be paid to the categorization of investment assets, notably the senior tranches of asset-backed securities ("ABS") such as credit card receivables, auto loans and student loans, and the senior tranches of commercial mortgage-backed securities ("CMBS"), which have strong underlying liquidity profiles but which receive very high RSF factors due to assumptions contained in the LCR. Custody banks, such as State Street, have balance sheets that are constructed differently than most universal banks with extensive commercial and investment banking operations. Unlike most other covered banks, custody banks make very few loans and do not undertake significant trading or other capital markets activities. Instead, the custody bank balance sheet is built around client deposits derived from the provision of core safekeeping and asset administration services. These deposits represent a stable source of long-term funding, whose value is monetized by custody banks via the purchase of large and well-diversified portfolios of high-quality investment assets. As currently

[4] Basel Committee Consultation, paragraph 25.

designed, the NSFR does not recognize the inherent stability and liquidity of this conservative balance sheet structure.

Third, we believe that it is important for the supervisory community to strive for the development of a liquidity framework that ensures a level playing field among internationally active banks. While we acknowledge the Basel Committee's efforts to develop a globally consistent standard, we note that national implementation is an important consideration in determining final outcomes. As an example, the US federal banking agencies have proposed to implement the LCR in a manner that broadly deviates from the Basel Committee standard. This includes a substantial narrowing of the scope of eligible high-quality liquid assets ("HQLA") and broad changes in the treatment of operational deposits. Since the NSFR has been designed to reflect core components of the LCR, the approach adopted by the US federal banking agencies has the potential to result in a long-term structural measure of liquidity that produces uneven results among global banks. We therefore urge the Basel Committee to continue to work with its supervisory members to minimize the scope of national discretion in liquidity regulation, including a commitment to review and revise material inconsistencies.

Our key policy recommendations, which are discussed in greater detail below, can be summarized as follows:

- An increase in the ASF factor for operational deposits, notably custody deposits, from 50% to 75%; and
- Recalibration of the RSF matrix to better accommodate senior tranches of ABS and CMBS with strong credit and liquidity characteristics.

We have participated in the development of the detailed responses submitted by various financial services trade groups, notably the joint letter from the Institute of International Finance, the International Capital Markets Association, The Clearing House Association and the Global Financial Markets Association, 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.

TREATMENT OF OPERATIONAL DEPOSITS

The Basel Committee's NSFR incorporates for the first time, operational deposits, which are assigned an ASF factor of 50%. State Street welcomes and strongly supports the decision to include operational deposits within the NSFR. This is an important step forward in recognizing one of the main building blocks of the custody bank balance sheet. It is also an approach that we have supported since the release of the Basel III Accord in late 2009. Still, we believe that the prescribed 50% ASF factor is far too conservative for use in a structural measure of liquidity. This is especially true for custody deposits, where there is strong empirical evidence of highly stable liquidity. As such, the 50% ASF factor runs the risk of producing an inaccurate picture of the funding profile of custody banks.

Unlike other liabilities, operational deposits are subject to stringent requirements which have grown progressively more onerous over time. As an example, the LCR, which forms the basis of the definitions contained in the revised NSFR, limits operational deposits to qualifying clearing, custody and cash management activities in which the client is reliant on the bank to perform services as an independent third party intermediary, where the bank is unaware of any back-up arrangements for such services that the client may have made, where the services are provided under a legally binding written agreement, and where termination of the agreement is subject to a notice period of more than 30 days or significant switching costs to be borne by the client. In addition, the LCR specifies that the operational deposit must be a by-product of the underlying services offered and not sought out in the wholesale funding market, and that the deposit must be held in a specifically designated account whose pricing does not provide the client with an economic incentive to leave excess funds in the account. Finally, covered banks must create a methodology for determining excess operational deposits and must exclude these from the operational deposit category.

Similarly, under proposed US rulemaking, operational deposits must meet a total of eight criteria, several of which are materially different that the international Basel Committee standard. This includes, among other, the requirement for a lack of significant volatility in the average balance of the deposit account, and the requirement that the covered bank "demonstrate that the deposit is empirically linked to the operational service and that it has a methodology for identifying any excess amount, which must be excluded from the operational deposit amount."[5]

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 acute short-term financial market stress, or over the longer-term horizon foreseen by the NSFR. We have provided the US federal banking agencies with empirical data that demonstrates the stability of our custody deposit base over a six-year period extending from January 2008 to December 2013. This is reflected in the close, linear relationship that exists between total assets under custody and operational deposits as defined in the LCR, throughout the reference period. We are happy to make this information available to the Basel Committee on a confidential basis, if it would prove helpful in better understanding policy outcomes.

In order to address this concern, we strongly urge the Basel Committee to amend the ASF factor for operational deposits, especially for highly stable custody deposits. Specifically, we believe that the ASF factor for operational deposits should be raised from 50% to 75%. This is consistent with their treatment under the LCR. This also mirrors the approach adopted by the Basel Committee for retail deposits, where the same stability factor is used for both the LCR and the NSFR. In view of the stringent and highly prescriptive requirements which apply to

[5] Board of Governors of the Federal Reserve, Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation – Proposed Rule: Liquidity Coverage Ratio: Liquidity Risk Measurement, Standards and Monitoring, Federal Register Volume 78, Number 230 (November 29, 2013), page 71859

operational deposits under the Basel Committee standard, we see no objective reason why such deposits should be singled out for more onerous treatment in the context of the NSFR.

We understand from conversations in various industry forums that the Basel Committee has certain concerns regarding the classification of operational deposits and therefore the potential for inconsistent treatment on a cross-jurisdictional basis. In response to this concern, the major US custody banks have submitted to the Basel Committee a joint comment letter that reflects a uniform approach to the treatment of operational deposits, based on a modified version of the standard proposed by the federal banking agencies in the context of the US LCR.[6] This includes an explicit definition of both operational deposits and operational services; qualifying criteria for operational deposits; and a common definition of excluded prime brokerage services and correspondent banking arrangements. We strongly support this approach as a reasonable basis for greater consistency in the treatment of operational deposits in the Basel Committee's liquidity framework, and therefore greater reassurance in assigning such deposits a more proportionate ASF factor of 75%.

One of the primary reasons for the introduction of a 25% outflow rate for certain wholesale deposits in the LCR was to recognize the liquidity value intrinsic in custody deposits. The decision to incorporate custody deposits within a more general category of operational deposits has tended to dilute the value of custody deposits and opened the door to broader categories of deposits where the operational ties are potentially less significant. As such, if national regulators continue to have concerns regarding the mis-categorization of various deposit balances as operational deposits, this should be addressed via the supervisory process rather than by ever more stringent limitations placed on a category of liabilities that is central to the custody bank business model. Indeed, one alternative that the Basel Committee may wish to explore is the introduction of a more granular approach, in which certain categories of operational deposits with highly stable funding profiles, notably custody deposits, are assigned a more favorable ASF factor above the base rate of 50%.

CALIBRATION OF REQUIRED STABLE FUNDING

The Basel Committee incorporates within the NSFR an RSF matrix, in which assets are categorized according to assumptions regarding the amount of funding required "either because (the asset) will be rolled over, or because (the asset) cannot be monetized through sale or used as collateral in a secured borrowing transaction over the course of one year without significant expense."[7] These range from 0% to 100% across seven discrete buckets, and is broken down by a combination of factors; specifically, continuity of credit creation, likely bank behavior, asset tenor, asset quality and liquidity value. In the case of asset quality and liquidity value, the Basel Committee notes that the NSFR assumes that "unencumbered high-quality

---

[6] Joint Comment Letter from Bank of New York Mellon, Northern Trust Corporation and State Street Corporation (April 11, 2014).
[7] Basel Committee Consultation, paragraph 25.

assets that can be securitized or traded, and thus can be readily used as collateral to secure additional funding or sold in the market, do not need to be wholly financed with stable funding."[8]

As proposed, the RSF matrix relies heavily on LCR parameters, with unencumbered Level 1 assets assigned to the 5% RSF category, unencumbered Level 2A assets assigned to the 15% RSF category and all unencumbered Level 2B assets assigned to the 50% RSF category. While we recognize the desire for continuity in liquidity regulation and also the relative simplicity of an approach based on pre-existing assumptions, we believe that the use of LCR parameters in the NSFR is inconsistent with a structural measure of funding. This reflects the very different liquidation periods which define the LCR and NSFR.

The LCR is specifically designed to ensure a bank's ability to withstand an acute period of short-term financial market stress. As per the Basel Committee, the "standard aims to ensure that a (covered) bank has an adequate stock of unencumbered HQLA that consists of cash or assets that can be converted into cash at little or no loss of value in private markets" over a 30-day horizon.[9] The LCR is therefore calibrated on the basis of a series of stringent assumptions regarding the ability to monetize assets in a stressed environment. This includes the lack of any recognition for assets which do not meet the criteria for inclusion in the stock of HQLA, even though many of these assets do in fact display strong structural liquidity. Among these are all non-residential mortgage ABS and all CMBS, which are assigned a uniform and highly punitive RSF factor of 85%.

ABS and CMBS are well-established financial products, used to facilitate access to consumer and commercial financing and to manage risk. Their importance in the promotion of stable and predictable funding is recognized by, among others, national central bank officials who have called for policy measures to support high-quality securitizations. As an example, Mario Draghi, President of the European Central Bank ("ECB"), recently stated that "we think that a revitalization of a certain type of ABS….capable of packaging together loans, bank loans, capable of being rated, priced and traded, would be a very important instrument for revitalizing credit flows and for our monetary policy."[10] Similarly, ECB Executive Board member Yves Mersch commented that "we should promote other forms of financing to complement the banking channel….and in particular securitization."[11] State Street is encouraged, in this respect, by recent press reports that the International Organization of Securities Commissions and the Basel Committee are considering the establishment of a working group to review the structure and functioning of the securitization markets.[12]

---

[8] Basel Committee Consultation, paragraph 13.

[9] Basel Committee on Banking Supervision, Basel III: The Liquidity Coverage Ratio and Liquidity Risk Monitoring Tools (January 2013), paragraph 16.

[10] European Central Bank President Mario Draghi, Press Conference and Q&A (February 6, 2014).

[11] European Central Bank Executive Board Member Yves Mersch, 'Investment and Investment Finance: Putting Europe on a Sustainable Growth Path (November 13, 2013)

[12] 'Global Regulators to Intensify Efforts to Revive Securitization', Reuters (March 17, 2014).

ABS and CMBS are structured as pooled investment vehicles backed by financial assets, typically loan receivables other than residential mortgages. They therefore benefit from stable and predictable cash flows, and are fully secured by the underlying loan receivables. Unlike investment grade corporate bonds, which are currently assigned more favorable RSF factors of either 15% or 50%, ABS and CMBS benefit from a series of credit enhancements designed to mitigate risk. This includes the use of a 'tranche' structure, characterized by a senior class of securities and one or more subordinated classes that function as a protective layer, assuming the first loss position in the event of a default on the underlying loan receivables. ABS and CMBS are typically structured with enhancements sized to prevent senior bond holders from realizing losses under a scenario that would generate exposures of between three to five times base-case loss assumptions. As such, senior bond holders are protected from loss in ABS and CMBS, unless the loss exceeds the full amount of the subordinated tranches.

Moreover, there are often additional credit protections built into ABS and CMBS which further insulate senior bond holders from losses. This includes reserve accounts and the collection of interest payments beyond what is immediately due to the bond holders. Similarly, Federal Family Education Loan Program ("FFELP") student loans, which are the dominant securitization structure in the US student loan market, are issued with a US government guarantee covering 97% to 98% of the underlying obligations. As such, in a scenario in which 100% of the underlying borrowers default on their student loans, FFELP securitizations might not experience even a single dollar of loss.

High-quality ABS and CMBS therefore have low and predictable risk-weights. As an example, a representative sample of the senior tranches of securitizations held by State Street encompassing credit card ABS, auto loan ABS, FFELP student loan ABS and CMBS, generate average risk weight charges under the Simplified Supervisory Formula Approach of between 20.0% and 21.8%. To the extent that it would be helpful, we are happy to provide the Basel Committee with a more granular view of this data on a confidential basis.

In addition to their stable credit profile, ABS and CMBS benefit from strong liquidity and broad acceptance among institutional investors. This includes banks, insurance companies, broker-dealers, pension funds, regulated mutual funds and alternative investment funds. According to industry data, there are nearly $2 trillion in outstanding ABS and CMBS.[13] This is roughly half the size of the US agency mortgage-backed securities market which, other than a handful of sovereign debt markets, is the most liquid fixed income market in the world. Securitized products, including ABS and CMBS, comprise nearly one-third of the Barclays Aggregate Bond Index by market value, thereby ensuring broad investor participation.

The below table offers information on recent and anticipated issuance in various key market segments:

[13] Financial Industry Regulatory Authority, Trade Reporting and Compliance Engine (TRACE), Q3 2013.

Sector	New Issuance Volume 2012	New Issuance Volume 2013	Exp. New Issuance Volume 2014
Auto ABS	$90 billion	$88 billion	$108 billion
Credit Card ABS	$40 billon	$36 billion	$52 billion
FFELP ABS	$25 billion	$18 billion	$14 billion
CMBS	$37 billion	$80 billion	$44 billion

Furthermore, ABS and CMBS benefit from robust secondary market liquidity. As an example, daily trading volumes in the third quarter of 2013 totaled $600 million for auto ABS, $400 million for credit card ABS, $195 million for student loan ABS (primarily FFELP) and over $2 billion for CMBS.[14] Moreover, transaction costs in a normal trading environment are modest, with bid-ask spreads ranging from 2 bps to 5 bps. As a result, most high-quality ABS and CMBS can be monetized in the private market, either via secured funding or via outright sale, and therefore represent a stable source of structural liquidity over the NSFR horizon. Furthermore, ABS and CMBS are eligible collateral in US and other central bank operations, and can therefore be monetized in normal course discount window transactions.

In order to ensure a more proportional regulatory outcome, we therefore recommend that the Basel Committee revise the RSF matrix to better accommodate the senior tranches of high-quality securitizations. More specifically, we suggest the use of a series of conservative standardized risk-weights for non-HQLA securities, as follows:

- Introduction of an RSF factor of 25% for unencumbered Level 2B residential mortgage-backed securities (this is consistent with their current treatment under the LCR);
- Use of the 50% RSF factor for all other unencumbered Level 2B assets, as well as unencumbered securities that do not qualify as HQLA, with a risk-weight of less than or equal to 35% under the Standardized Approach;
- Adjustment of the 65% RSF factor to include unencumbered securities that do not qualify as HQLA, with a risk-weight greater than 35% but not more than 50% under the Standardized Approach (this might also include a corresponding increase in the risk-weight for associated unencumbered loans);
- Use of the 85% RSF factor for unencumbered securities that do not qualify as HQLA, with a risk-weight greater than 50% under the Standardized Approach.

Without these changes, we believe that the NSFR will produce an inaccurate measure of the liquidity profile of many high-quality ABS and CMBS routinely held by covered banks, thereby undermining an important source of market-based funding and requiring costly changes to balance sheet structures unsupported by an empirical assessment of funding risk.

[14] Financial Industry Regulatory Authority, Trade Reporting and Compliance Engine (TRACE), Q3 2013.

CONCLUSION

Thank you once again for the opportunity to comment on the matters raised within this Consultation. To summarize, we welcome the Basel Committee's efforts to strengthen the liquidity profile of covered banks, including the use of the NSFR as a measure of structural liquidity over a one-year horizon. In order to improve policy outcomes, we recommend that the design of the NSFR be informed by three considerations namely; the proper recognition of varying industry business models, careful calibration as a structural rather than stressed measure of liquidity, and renewed efforts to ensure a level playing field among internationally active banks.

In addition, we suggest that the Basel Committee make two targeted adjustments to the intended framework. The first is an increase in the ASF factor for operational deposits, especially custody deposits, from 50% to 75%, in a manner consistent with their treatment under the LCR. The second are several targeted revisions to the proposed RSF matrix designed to more accurately reflect the funding profile of the senior tranches of high-quality securitizations routinely held by covered banks, such as credit card ABS, auto loan ABS, FFELP student loan ABS and CMBS.

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

Sincerely,

Stefan M. Gavell