March 27, 2015

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 – Revisions to the Standardized Approach for Credit Risk**

Dear Sir/ Madam:

State Street Corporation, The Bank of New York Mellon Corporation and The Northern Trust Corporation (the "Custody Banks") appreciate the opportunity to comment on the Consultative Document ("Consultation") issued by the Basel Committee on Banking Supervision ("Committee") regarding revisions to the standardized approach for credit risk.

State Street specializes in providing institutional investors with investment servicing, investment management and investment research and trading. With $28.2 trillion in assets under custody and administration and $2.5 trillion in assets under management as of December 31, 2014, State Street operates in more than 100 geographic markets.

The Bank of New York Mellon Corporation (BNY Mellon) is a global investments company that provides investment management and investment services to help institutions and individuals invest, conduct business, and transact in markets all over the world. BNY Mellon operates in over 100 markets, with $28.6 trillion assets under custody and administration and $1.7 trillion assets under management as of December 31, 2014.

Northern Trust Corporation is a leading provider of wealth management, asset servicing, asset management and banking to corporations, institutions, affluent families and individuals. As of December 31, 2014, Northern Trust had assets under custody of $6 trillion, and assets under management of $934 billion.

Our letter is divided into six sections:1) the role of custody banks in securities lending markets; 2) current regulatory initiatives related to securities lending; 3) the current and proposed capital treatment of indemnified securities financing transactions ("SFTs"), 4) flaws with the proposed methodology; 5) suggested alternatives; and 6) negative impacts of excessively limiting securities lending.

While we share many of the concerns raised by numerous commenters on the Consultation, our joint comments today focus specifically on the measurement of credit exposure for indemnified agency SFTs[1], where the Custody Banks play a key role in global financial markets.

Simply stated, while we do not disagree with the Committee's decision to minimize or eliminate the use of internal models under the Standardized Approach, we believe the proposed comprehensive approach described in the Consultation will result in a significantly inaccurate and misleading methodology for measurement of risk for indemnified agency SFTs, due largely to the lack of recognition of correlation between lent securities and posted collateral.

The comprehensive approach, both under the existing standardized approach and the revisions suggested in the Consultation, is intended to provide banks the ability to reflect the risk mitigating effects of collateral in capital calculations. As part of this calculation, banks must adjust for possible volatility in the market values of securities lent or received as collateral, based on haircuts prescribed by the Committee. Banks must also adjust for potential foreign exchange volatility for cross-currency transactions. While we do not disagree with the general principles underlying this approach, in the case of SFTs, we believe an accurate representation of credit risk requires additional adjustments which are not currently included in the Committee's approach, particularly for correlation in potential market value changes between securities.

As a result, we strongly urge the Committee to consider a more accurate, yet still conservative, approach. Specifically, we suggest the Committee propose a revised, non-internal models methodology for measuring credit exposure from indemnified agency SFTs. We outline three potential options for such a non-internal models approach below, and would be pleased to discuss further as the Committee considers further work on its Consultation.

### 1) Role of custody banks in securities lending markets

Agency securities lending through custody banks is a subset of the broader SFT market, focused on demand driven borrowing of securities from the Custody Banks' institutional investor customer base. Borrowers, generally large broker-dealers, receive securities (not cash), and post cash or non-cash collateral. Beneficial owners (typically large pension funds, mutual funds, or endowments), lend securities secured by cash and non-cash collateral. Transactions are always over collateralized, with the lender received collateral valued at 102-112% of the lent security. Loan and collateral positions are marked to market daily.

The Custody Banks act as agents, and are not principals to the transaction. As fitting in their role as agents, neither the lent security nor the posted collateral (cash or non-cash) appear on the Custody Banks' balance sheets, and cash collateral is reinvested on the behalf of and at the instruction of the beneficial owner of the lent security.

Securities borrowers pay fees in connection with the transaction. Beneficial securities owners generate incremental yield, at low-risk for investors, and receive the majority of the revenue associated with agency lending transactions. The Custody Banks, acting as agent lender, receive fees from Beneficial Owners for providing certain services, including:

- Relationships and credit risk assessment for a wide range of borrowers;

[1] While our comments focus primarily on indemnified agency lending transactions, they apply equally to similar indemnified repo transactions, which typically mirror security lending transactions, and in which the custody bank provides an indemnification to its buy-side client against broker-dealer default.

- Systems expertise and economies of scale;
- Monitoring, mark-to-market and exchange of collateral;
- Optional reinvestment of cash collateral (under lending investment guidelines); and
- Indemnification for return of securities in cases of borrower default.

Most asset owners would be unable or unwilling to lend securities without the services of an agent lender.

### 2) Current regulatory initiatives related to securities lending

The proposed changes to capital rules related to the measurement of credit exposure resulting from of securities lending (and other SFTs) is one of numerous ongoing regulatory initiatives with substantial implications for the securities lending markets.

Like the pending Consultation, development of enhanced large exposures limits[2] depends on the measurement of credit exposure resulting from indemnified agency SFTs, and the original Basel Committee proposal based this calculation on the Committee's existing comprehensive approach. As proposed, the Basel large exposures framework could have reduced securities lending volumes by up to 40%. The final large exposures agreement deferred to the Committee's Standardized Approach review for further exploration into non-internal models based methods, and we expect the outcome of the pending Consultation will be relevant as individual jurisdictions consider future large exposure and similar rulemakings.

Securities lending is also within the scope of the Financial Stability Board's shadow banking agenda, where changes have been adopted or are being considered related to cash collateral reinvestment, transparency, and minimum collateral haircuts for funding-driven SFTs. The Custody Banks are generally supportive of the changes being proposed through the FSB shadow banking workstream.

In addition, the use of SFTs for balance sheet funding purposes is a significant factor in policy-makers' efforts to limit or penalize the use of short-term wholesale funding by banks. The proposed U.S. G-SIB surcharge, for example, goes beyond the G-SIB surcharges agreed to in Basel and at the FSB, and increases the surcharge for U.S. bank holding companies, in part through a new risk factor based on short-term wholesale funding.

The Committee's proposal on revisions to the standardized approach is only one element in the existing and emerging regulatory framework for securities lending transactions and other SFTs.

### 3) The current and proposed capital treatment of indemnified SFTs

Unlike principal activity of banks, agency activities typically do not result in a direct credit exposure for purposes of a bank's capital requirements. Due to the indemnification provided to the lender for return of securities upon a borrower's default, however, indemnified agency SFTs do have capital implications for the Custody Banks.

The capital treatment of such exposures from indemnified lending activity varies, depending on the specific regulatory capital ratio.

[2] Single counterparty credit limits, or SCCL, in the United States.

For the Basel III leverage ratio (i.e. the U.S. supplemental leverage ratio), the Basel Committee distinguishes between indemnified agency lending, which is measured based on current exposure, and principal activity, which is measured on a gross exposure basis.

For risk weighted capital, indemnified agency SFTs are treated identically to principal lending by the indemnifying agent bank, resulting in a credit exposure to the securities borrower under both the Basel standardized and advanced approaches. These credit exposures can be measuring using a variety of techniques, including a highly risk-insensitive volatility “look-up table,” or a more risk-sensitive approved simple VaR methodology.

Under supervisory guidance issued by the U.S. Federal Reserve under Basel I, the Custody Banks had used the simple VaR methodology to calculate part or all of such regulatory capital exposures since 2003, and continue to use approved simple VaR models for risk management purposes and for the current Advanced Approaches methodology. While the simple VaR method is currently permitted under the Committee’s Standardized Approach (i.e., before the revisions proposed by the Consultative Document), the U.S. implementation of Basel III does not permit its use for the Standardized Approach. As a result, the Custody Banks currently use the risk-insensitive volatility “look-up” table under the Committee’s Comprehensive Approach to calculate exposures under the Standardized Approach[3].

The existing Comprehensive Approach results in an inaccurate and vastly overstated measurement of the actual risk of indemnified agency SFTs. The proposed treatment of indemnified agency SFTs in the Consultative Document exacerbates these problems by increasing volatilities in the “look-up” table.

## 4) Flaws with the proposed methodology

The final result of the U.S. adoption of Basel III and the changes proposed by the Committee in the consultative document will be mandatory use of the “look-up” table approach in the Committee’s Comprehensive Approach for all banks using the standardized approach. As noted above, all U.S. banks, including those using the advanced approach, must also use the standardized approach. As a result, the securities lending businesses of U.S. banks (including the Custody Banks) are already constrained by the unfavorable treatment of SFTs under the standardized approach, and non-U.S. banks will be similarly constrained once the Committee concludes its work on a global risk weighted capital floor based on the standardized approach.

This approach to measuring credit exposure from securities lending transactions is highly non-risk sensitive and flawed for numerous reasons:

- Most importantly, the approach assumes a negative correlation of 100% between loans and collateral. Under this approach, for example, loaned shares of Dell are assumed to appreciate at the same time posted shares of IBM collateral decline;
- There is no recognition of diversification within the lending or collateral portfolio;
- There is no meaningful recognition of netting;
- There is no recognition of “flight to quality” in times of stress, when certain security types (e.g. equities, corporate bonds) would be expected to fall in price while other “safe” assets (e.g. Treasuries) would be expected to rise;
- The adjustment for cross-currency transactions greatly overstates the volatility (approximately double) for most currency pairs; and

[3] Note that U.S. banks, unlike non-US internationally active banks, must, under the “Collins Amendment” to the Dodd Frank Act, meet the risk weighted capital requirement under both the Standardized and Advanced approaches.

- The volatilities prescribed in the “look-up” table are themselves non-risk sensitive and lacking in granularity. The changes proposed in the Consultation are even more punitive than the existing standardized approach.

As a result, the current and proposed frameworks, when combined with the more conservative counterparty weighting scheme under the proposal, using the Comprehensive Approach overstate credit risk by up to 50 times over existing approved simple VaR models used under the advanced approach for certain transactions.

**5) Suggested alternatives**

We do not disagree with the Committee that the use of internal models, such as simple VaR currently used by most agent lenders under the advanced approach, should be prohibited under the standardized approach. While we continue to believe simple VaR models provide the most accurate insights into likely credit losses due to indemnified agency SFTs, we understand the Committee’s interest in proscribing methods for the standardized approach that are simple, comparable, and conservative.

We strongly urge the Committee, however, to consider other non-internal models approaches as alternatives to the highly risk-insensitive “look-up” table approaches required under current U.S. rules and the Committee’s Consultation.

There are several options the Committee can consider to create an improved non-internal models based approach for indemnified agency SFTs[4]. We propose three possible alternatives, each of which is described in greater detail in Appendix A:

- Alternative A --- A regulatory input method, where regulators would mandate a specific formula for calculating exposures and provide all relevant assumptions on volatilities and correlations. Banks would simply enter data on loans and collateral positions into the regulatory formulas for purposes of determining exposures.
- Alternative B --- A revised comprehensive approach which uses a “look up” table similar to the existing Basel comprehensive approach, but incorporates correlations and other factors as determined by regulators. The revised table would measure exposures based on the combinations of securities loaned and the collateral posted.
- Alternative C --- A modified version of the Committee’s SA-CCR methodology (for derivatives), customized for indemnified agency SFTs.

Each of these alternatives provides a non-internal models based approach for securities lending exposures which provides regulators full control over all relevant assumptions, including volatilities and correlations, but establishes far more accurate measurements of credit exposure than the approach proposed in the Consultation while still remaining conservative. Pro forma analysis of the three alternatives is provided in Appendix B, where our analysis of a sample, simple lending portfolio shows each of our proposed alternatives resulting in credit exposures considerably higher than the simple VaR methodology, but lower than the current or proposed risk-insensitive standardized approach “look up” table.

[4] While we focus on indemnified agency securities lending, we believe these approaches are equally appropriate for principal lending or other forms of SFTs. We understand the comprehensive approach may also be used for other types of exposures, such as margin lending and derivatives; we would not expect the proposed changes to be used for those purposes.

### 6) Negative impacts of excessively limiting securities lending

We support and have participated in the post-crisis regulatory review of issues surrounding securities lending, and endorse many of the resulting adopted or pending regulatory changes, particularly those intended to increase reporting and transparency, there are negative consequences to imposing unduly limiting requirements for securities lending markets.

Securities lending provides numerous benefits to investors and the financial markets, which could be lost if such transactions became economically nonviable due to inaccurate measures of credit exposure and risk-weighted assets for the Custody Banks.

First, reducing the ability of asset owners to lend securities will lower returns for investors. Securities lending typically adds 5bps to pension or investment fund yields. Investors received approximately $8.3b from securities lending over the last 12 months.

Second, securities lending lowers spreads in securities markets, and increases liquidity.

Third, securities lending helps smooth settlements in the securities markets; unduly limiting securities lending will increase the likelihood of failed transactions.

Fourth, unduly limiting securities lending transactions will reduce the availability of high-quality, liquid assets to meet new swaps collateral and other mandates.

Finally, imposing unreasonable and unrealistic measures of credit exposure on the Custody Banks will result in a shift of the lending business outside of the banking system to non-bank agent lenders, who are beyond the reach of risk-based capital rules.

## Conclusion

In conclusion, we urge the Committee to use its ongoing review of the standardized approach to explore new non-internal models based approaches for measuring credit risk resulting from indemnified agency SFTs that more accurately measure the risk of such exposures while remaining conservative.

Please to not hesitate to contact the undersigned with any questions:

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## APPENDIX A

# ALTERNATIVE A: REGULATORY INPUT METHOD

$$\text{Exposure} = \sqrt{(L*\delta_1)^{\wedge 2}+(-C*\delta_2)^{\wedge 2}+2*(L*\delta_1)*(-C*\delta_2)*-\rho} \quad - \quad (C-L)$$

Where:

**L** = loan value

**δ1** = volatility of Lent Security

**C** = collateral value

**δ2** = volatility of Collateral Security

**P** = correlation between lent security and collateral security

Proposed Approach – Loan value and collateral value are from the bank; δ1, δ2, ρ are all standardized by the regulators at an asset class level based on 99th percentile estimates under stressed scenarios.

Advanced Approach (for comparison) – All variables are internally derived by the bank.

# ALTERNATIVE B: REVISED COMPREHENSIVE APPROACH

$$\text{Exposure} = (L * h(L/C) + ((C-L)*h(C)) - (C-L)$$

Where:

**L** = Loan Value

**C** = Collateral Value

**h(L/C)** = haircut for loan/collateral combination (examples provided in the table below);

**h(C)** = haircut for collateral vs. cash

| Haircut Percentages | | **Cash** | **0% Weighted Sovereigns** | **0% Weighted Sovereigns** | **0% Weighted Sovereigns** | **20% - 50% Weighted Sovereigns** | **20% - 50% Weighted Sovereigns** | **20% - 50% Weighted Sovereigns** | **Corp/Muni** | **Corp/Muni** | **Corp/Muni** | **Equity** |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | <1 year | 1-5 year | >5 year | <1 year | 1-5 year | >5 year | <1 year | 1-5 year | >5 year | |
| **Cash** | | 0.0% | 0.1% | 1.2% | 2.8% | 0.5% | 2.1% | 6.7% | 1.2% | 6.9% | 13.7% | 15.0% |
| **0% Weighted Sovereigns** | <1 year | 0.6% | 0.5% | 1.2% | 2.4% | 0.7% | 1.9% | 5.2% | 1.1% | 5.1% | 9.9% | 12.3% |
| **0% Weighted Sovereigns** | 1-5 year | 1.6% | 1.2% | 2.1% | 3.3% | 1.6% | 2.8% | 6.2% | 1.8% | 6.0% | 11.2% | 14.0% |
| **0% Weighted Sovereigns** | >5 year | 2.8% | 2.1% | 3.0% | 4.1% | 2.4% | 3.5% | 7.0% | 2.7% | 7.1% | 12.0% | 14.8% |
| **20% - 50% Weighted Sovereigns** | <1 year | 0.9% | 0.7% | 1.6% | 2.7% | 1.1% | 2.3% | 5.6% | 1.4% | 5.4% | 10.1% | 12.0% |
| **20% - 50% Weighted Sovereigns** | 1-5 year | 2.1% | 1.6% | 2.5% | 3.5% | 2.0% | 3.2% | 6.5% | 2.2% | 6.4% | 11.2% | 13.0% |
| **20% - 50% Weighted Sovereigns** | >5 year | 1.8% | 1.4% | 2.3% | 3.4% | 1.7% | 2.9% | 6.4% | 2.0% | 6.4% | 11.3% | 13.1% |
| **Corp/Muni** | <1 year | 1.7% | 1.2% | 1.9% | 3.0% | 1.4% | 2.5% | 5.6% | 1.7% | 5.4% | 10.2% | 12.0% |
| **Corp/Muni** | 1-5 year | 1.6% | 1.2% | 2.0% | 3.2% | 1.5% | 2.7% | 6.1% | 1.8% | 5.7% | 10.9% | 13.3% |
| **Corp/Muni** | >5 year | 3.3% | 2.4% | 3.3% | 4.4% | 2.6% | 3.9% | 7.3% | 3.0% | 7.3% | 12.1% | 15.0% |
| **Equity** | | 6.2% | 5.0% | 6.2% | 7.5% | 5.0% | 6.3% | 9.9% | 5.3% | 10.4% | 16.2% | 11.8% |

**Using existing US-adopted volatilities**
99% most positive / most negative index – index correlations
99% most positive / most negative security – index correlations
Adjusted to account for right way / wrong way risk, resulting in a higher haircut for exposure pairs with lower quality collateral and lower haircut for instances of higher quality collateral

# ALTERNATIVE C: SA-CCR FOR SECURITIES LENDING

Securities Finance Loan and Collateral types would be mapped to one or more of the existing SA-CCR asset classes:

- **Equity Securities** = Equity Derivatives
- **Fixed Income** = Interest Rate and Credit Derivatives
- **Loan and Collateral Currency Mismatch** = Foreign Exchange Derivatives

Loans would be treated as a short derivative exposure and collateral would be treated as a long derivative exposure.

The maturity adjustment should be set at 5 days for liquid securities and 20 days for illiquid securities, consistent with current SFT treatment.

Under the EAD formula:
**EAD** = alpha * (RC + PFE), RC would be zero
**For SFTs EAD** = alpha * PFE

## APPENDIX B

# PRO-FORMA MODEL RESULTS

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| | Lend | | Receive | | | | Net Exposure |
| | Ford | 100 | 10 year UST | 102 | | | |
| Basel III Standardized | | | | | | | 11.5 |
| Regulatory Input | | | | | | | 6.2 |
| Revised Comprehensive | | | | | | | 7.9 |
| Basel I (w/exemption) | | | | | | | 5.8 |
| SA-CCR | | | | | | | 9.4 |
| | | | | | | | |
| | 2 Year UST | 100 | GM | 108 | | | |
| Basel III Standardized | | | | | | | 4.4 |
| Regulatory Input | | | | | | | 8.3 |
| Revised Comprehensive | | | | | | | 4.8 |
| Basel I (w/exemption) | | | | | | | 1.9 |
| SA-CCR | | | | | | | 6.3 |
| | | | | | | | |
| | GE | 100 | Cash | 102 | | | |
| Basel III Standardized | | | | | | | 8.6 |
| Regulatory Input | | | | | | | 4.2 |
| Revised Comprehensive | | | | | | | 4.2 |
| Basel I (w/exemption) | | | | | | | 3.9 |
| SA-CCR | | | | | | | 8.2 |
| | | | | | | | |
| Portfolio | | 300 | | 312 | | Gross Exposure | Net Exposure |
| Basel III Standardized | | | | | | 36.5 | 24.5 |
| Regulatory Input | | | | | | 25.2 | 13.2 |
| Revised Comprehensive | | | | | | 23.3 | 11.3 |
| Basel I (w/exemption) | | | | | | 8.3 | 0.0 |
| SA-CCR | | | | | | | 10.5 |

**Basel III Standardized** = Proposed large exposures methodologies
**Regulatory Input** = Proposed alternative, with asset class volatilities based on proposed haircuts shifted to reflect flight to quality, and stressed correlations at the $99^{th}$ percent highest (for loan vs. loan and collateral vs. collateral) and lowest (loan vs. collateral)
**Revised Comprehensive** = Proposed Alternative using haircuts for loan and collateral pairs based on proposed haircuts shifted to reflect flight to quality, and stressed correlations at the 99th percent highest (for loan vs. loan and collateral vs. collateral) and lowest (loan vs. collateral)
**Simple VaR** = VaR derived using the variance-covariance methodology and one year volatilities and correlations
**SA-CCR** = SA-CCR adjusted for SFT transactions, using prescribed formulas for derivatives