



March 11, 2016

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

Second 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 Second Consultative Document (the “Second Consultation”) issued by the Basel Committee on Banking Supervision (the “Committee”) regarding revisions to the standardized approach for credit risk.¹

State Street Corporation specializes in the provision of financial services to institutional investor clients. This includes investment servicing, investment management, data and analytics, and investment research and trading. With \$27.51 trillion in assets under custody and administration and \$2.25 trillion in assets under management as of December 31, 2015, State Street operates in 29 countries and 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 \$28.9 trillion assets under custody and/or administration and \$1.6 trillion assets under management as of December 31, 2015.

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

¹ ‘Second Consultative Document - Revisions to the Standardized Approach for Credit Risk’, Basel Committee on Banking Supervision (December 2015).

31, 2015, Northern Trust had assets under custody of \$6 trillion, and assets under management of \$875 billion.

As with the Custody Bank's joint submission on the Committees first consultation in this area in March, 2015,² while we share many of the views raised by industry associations and other commentators on the present Consultation, our joint comments today focus on certain elements of the Consultation most relevant to the banks operating under a custodial bank business model, particularly the measurement of credit exposure for indemnified agency securities financing transactions ("SFTs"), where the Custody Banks play a key role in global financial markets.³

The Custody Banks strongly support the new approach to SFTs proposed in the Second Consultation, which we believe will provide a far more accurate, though still highly conservative, measurement of credit exposures for SFTs, and which we believe addresses many of the concerns raised in our March 2015 comments.

In addition to SFTs, our comments today focus on two other aspects of the Second Consultation that are important to custody banks' ability to provide services to their institutional investor customers: (i) the lack of recognition of the extremely low historic draw rates for unfunded commitments to regulated investment funds (such as U.S. mutual funds and European UCITS), and (ii) the exclusion of certain institutional investment entities from the more favorable treatment provided to "investment grade" corporates under the proposed regime.

Further detail on each of these topics is provided below, but in summary, the Custody Banks urge the Committee to:

- Adopt the revised exposure methodology for SFTs proposed in the Second Consultation;
- Introduce a 20% credit conversion factor ("CCF") for committed lines of funding to regulated investment funds; and
- Adjust the definition of "investment grade" to eliminate the requirement that such a counterparty "must have securities outstanding on a recognized securities exchange."

Securities Financing Transactions

The Custody Banks do not disagree with the Committee's decision to eliminate the use of internal models under the Standardized Approach. As noted in our March 2015 comment letter, the Custody Banks had serious concerns with the approach proposed in the Committee's First Consultation, which proposed a revised version of the existing comprehensive approach and required banks' engaging in

² 'Consultative Document – Revisions to the Standardized Approach for Credit Risk', State Street Corporation, Bank of New York Mellon Corporation and Northern Trust Corporation Comment Letter (March 27, 2015).

³ As with our March, 2015 submission, while our comments today focus primarily on indemnified agency securities 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.

SFTs to adjust for possible volatility of the market values of securities lent or received as collateral based on haircuts prescribed by the Committee.

We pointed out numerous flaws with the Committee's proposed approach in our March 2015 comment letter, including:

- The assumed 100% negative correlation between loans and collateral;
- The lack of recognition of diversification within the lending and collateral portfolios;
- The lack of meaningful recognition of netting;
- The lack of recognition of "flight to quality" in times of stress;
- The overstatement of volatility for cross-currency transactions; and
- The lack of risk-sensitivity in the prescribed volatilities.

The Second Consultation takes a different approach than the First Consultation, and proposes a new non-internal model based methodology for SFTs covered by master netting agreements. This approach retains the prescribed volatility haircuts of the comprehensive approach, but makes adjustments to the exposure to better account for diversification and correlation.

The Custody Banks believe the new proposal included in the Second Consultation addresses the key deficiencies of the First Consultation, while still resulting in exposures for SFTs that are significantly greater (in some cases as much as 7x to 10x greater) than those resulting from the simple VaR methodology currently used under the Committee's Advanced Approaches.

The Custody Banks strongly support adoption of the exposure calculation methodology for SFTs covered by master netting agreements proposed in the Second Consultation in the Committee's final agreement on revisions to the Standardized Approach.

Unfunded Commitments to Investment Funds

The Custody Banks are concerned with the Committee's "one-size-fits-all" approach to unfunded commitments.

The Custody Banks regularly provide committed lines of funding to their institutional investor customers, including regulated investment funds such as US mutual funds and similar non-US equivalents, such as European UCITs. Such investment funds provide investment opportunities to the retail investor community, and are subject to substantial regulation related to transparency, asset quality, diversification and leverage. The committed lines of credit provided to such funds are used to facilitate the day-to-day operations of the fund, and allow the fund to efficiently and smoothly address unanticipated client redemptions, expense payments, and other similar movement of cash, and are typically of very short tenor. The lines of credit provided by the Custody Banks to regulated investment funds are essential to the efficient operation of such funds, and to financial markets.

Committed lines provided to regulated investment funds create low credit risk, and, in our experience, are very unlikely to experience significant draw-downs, even in times of crisis. As a result, the assumed credit conversion factor in the Committee's proposed revisions to the Standardized Approach of

between 50-75% greatly overstates the exposure of the Custody Banks to these regulated investment fund counterparties.

The Custody Banks urge the Committee to adopt credit conversion factor of 20%⁴ for committed lines of funding provided to regulated investment companies.

While our recommendation above is specific to lines of credit to regulated investment companies, we note that there are numerous other areas where the Committee should refine its approach to credit conversion factors to differentiate between product types with varying draw down characteristics. For example, conditional commitments that require customers to post or increase collateral at the time they draw down the commitment have lower draw down rates than other types of commitments, due to the cost imposed by the higher collateral allocation. The Committee should consider a separate and reduced CCF for such products.

Investment Fund Counterparties

The Custody Banks generally support the efforts of the Committee to address issues raised by certain jurisdictions' prohibitions against the use of credit ratings in regulations, such as the creation of a definition of "investment grade" entities in Paragraph 173 of the Second Consultation. We are concerned, however, that the requirement that such corporate entities "must have securities outstanding on a recognized securities exchange" may unduly limit the benefits of such a designation for our institutional investor client base.

As noted above, the Custody Banks service institutional investor clients, including regulated investment funds, bank collective funds, public and private pension plans, charitable foundations and endowments, and sovereign wealth funds. While such entities fall within the broad category of "corporates" for purposes of the Committee's capital framework, they are not "corporates" in the traditional sense of an operating company, and have no compelling reason (or, often, ability) to issue securities in the market. This includes, for example, US mutual funds, EU UCITS, and other similar non-US equivalents, which, although registered, are not structured as securities issuances.

While such funds may well be able to meet the Committee's proposed standard in Paragraph 173 of having "adequate capacity to meet their financial commitments (including repayment of principal and interest) in a timely manner, irrespective of the economic cycle and business conditions," they would still not be eligible as "investment grade" entities under the Committees proposed approach, due to their lack of "securities outstanding on a recognized securities exchange."

The Custody Banks see no reason that otherwise eligible investment fund entities should not be considered "investment grade" corporates for purposes of the Standardized Approach, and we urge the Committee to eliminate the requirement of having "securities outstanding on a recognized securities exchange" for such entities.

⁴ Consistent with the proposed credit conversion factor for trade finance commitments.

Conclusion

Once again, the Custody Banks appreciate having the opportunity to comment on the Committee's proposed revisions to the Standardized Approach. While we continue to have concerns with certain elements of the proposed changes, as described above, our primary concern remains the appropriate measurement of credit exposures from indemnified agency securities lending, and we applaud the Committee for its significant work in this area. We strongly support the revised approach proposed in the Second Consultation, and urge the Committee to include this new, non-internal models based methodology in its final revisions to the Standardized Approach.

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; Kelly King Dibble, Northern Trust Corporation, at (202) 303-1710 or kkd2@ntrs.com; or Rob McKeon, Vice President, State Street Corporation, at (617) 664-7632 or ramckeon@statestreet.com.

Respectfully submitted,



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