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Secretariat of the Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel
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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 (“State Street”) welcomes the opportunity to comment on the Consultative Document (“Consultation”) issued by the Basel Committee on Banking Supervision (“Basel Committee”) regarding revisions to the standardized approach for credit risk. This consultation forms part of a broader effort by the Basel Committee to review and amend regulatory capital standards for internationally active banks in order to improve consistency in the measurement of risk-weighted assets and ensure that the standardized approach constitutes a suitable ‘alternative and complement’ to internal models in the assessment of risk.¹ While we recognize growing supervisory interest in robust standardized methodologies, we are concerned that the framework proposed by the Basel Committee does not accurately reflect the particular characteristics of certain industry business models, notably that of global custody banks, and therefore results in the inaccurate assessment of underlying credit risk.

Headquartered in Boston, Massachusetts, 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, State Street operates in 29 countries and in more than 100 geographic markets. State Street is organized as a United States (“US”) bank holding company (“BHC”), with operations conducted through several entities, primarily its wholly-owned bank subsidiary, State Street Bank and Trust Company. As a US BHC, we are subject to Section 171 of the Dodd-

¹ Basel Committee Consultation, page 1.

Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”), also known as the ‘Collins Amendment’, which imposes a statutory capital floor on certain US banking institutions based upon the ‘generally applicable risk-based capital requirement’. We therefore report and are subject to the lowest of our risk-based capital ratios calculated under both the standardized and advanced approaches. As of December 31, 2014, our Basel III advanced approach common equity Tier 1 ratio was 12.5% and our *pro forma* Basel III standardized approach common equity tier 1 ratio was 10.8%.

Our perspective in respect of the Consultation is broadly informed by our status as one of the world’s largest providers of custody services to institutional investor clients. These clients include asset owners, asset managers and official institutions, and encompass US mutual funds and their non-US 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 Basel Committee’s Consultation on our role as custodial intermediary, 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.

INTRODUCTORY COMMENTS

State Street recognizes the growing emphasis among supervisory authorities on improving the design and calibration of standardized measures of capital. We also acknowledge many of the limitations identified by the Basel Committee in the prevailing standardized approach for credit risk, including excessive reliance on external credit ratings, the need for greater risk-sensitivity, the scope provided for national discretion and the lack of consistency between standardized and advanced methodologies. Furthermore, we support the high-level principles identified by the Basel Committee for the development and evaluation of various policy alternatives. This includes the emphasis on ‘capital charges... (that) reflect to a reasonable extent, the risk of the exposures and (that) provides the correct incentives for banks....The standardized approach should provide a meaningful differentiation of risk, with the ultimate goal of improving...risk-sensitivity’.² Moreover, we strongly welcome the Basel Committee’s assertion that ‘capital requirements should be commensurate with the underlying risk’ and that ‘equal risks should attract the same amount of capital’.³

While we acknowledge the inherent challenges in developing a framework that properly balances risk-sensitivity and simplicity, and that can be broadly applied across banks of various size, scope and sophistication, we are concerned that several of the methodologies proposed by the Basel Committee for the measurement of exposures to credit risk do not properly

² Basel Committee Consultative Document, page 5.

³ Basel Committee Consultative Document, pages 2 and 4.

account for the particular characteristics of the custody bank business model. This includes the important role played by custody banks in the provision of appropriately regulated services to investment funds, which help support financial market efficiency and stability and therefore a reduction in potential systemic risk. More specifically, we have reservations regarding the proposed methodology for the measurement of exposures to agency-indemnified securities financing transactions (“agency-indemnified SFT”), the intended measure of exposure to investment fund counterparties and the prescribed credit conversion factor (“CCF”) for unfunded commitments to regulated funds. We therefore recommend several adjustments to the Basel Committee’s intended framework, designed to improve risk-sensitivity and avoid the prospect of unwarranted changes to our well-established and highly-stable business model.

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

- The development of a revised and appropriately risk-sensitive non-internal model-based methodology for the measurement of exposures to agency-indemnified SFT;
- The introduction of an amended approach for the measurement of exposures to investment fund counterparties, involving the use of the ‘investment grade’ standard in US prudential regulation, and in the case of funds which are ‘non-investment grade’, the use of a look up table combining both leverage and liquidity;
- The maintenance of the current CCF for unfunded commitments based upon length to maturity, or the introduction of a specific CCF for committed liquidity/ redemption lines provided to regulated investment funds.

We have participated in the development of the detailed responses submitted by various financial services trade groups, notably comments from The Clearing House 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 that result from our custody bank business model.

CUSTODY BANK BUSINESS MODEL

Global custody banks, such as State Street, are uniquely focused on serving the investment needs of their institutional investor clients. These clients contract with custody banks to ensure the proper safekeeping of their investment assets, as well as the provision of a broad range of associated financial services. This includes access to the global settlement infrastructure in order to complete the purchase or sale of investment securities; various asset administration functions, such as the processing of income and other interest payments, corporate action events, tax reclamations and client subscriptions and redemptions; and the provision of banking services, notably access to deposit accounts in order to facilitate day-to-day transactional activities. In addition, custody banks provide a series of value added services that result from their proximity to assets held in custody, notably agency-indemnified SFT.

Custody banks therefore play an important role in facilitating access to, and the smooth operation of, financial markets. This is encouraged by supervisory authorities as a way of avoiding bottlenecks that would otherwise hamper market efficiency and exacerbate potential systemic risk. Moreover, custody banks such as State Street have balance sheets that are constructed differently than other internationally active banks with extensive retail, commercial, investment banking and capital markets operations. 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 funding, whose value is monetized via the purchase of large and well-diversified portfolios of high-quality and appropriately termed investment assets. Unlike other more traditional banks, custody banks make relatively few loans and do not engage in the asset securitization process. Furthermore, they do not engage in significant trading activities and do not rely extensively on sources of wholesale funding to manage their business activities or balance sheets.

As such, standardized methodologies derived for more traditional industry business models have the potential to overlook key components of the custody bank business model, and therefore to inaccurately assess the extent of underlying credit risk. Nevertheless, we believe that this concern can largely be addressed via a series of targeted adjustments to the intended standardized framework, without undermining the Basel Committee's policy goals. These adjustments are further described below.

SECURITIES LENDING TRANSACTIONS

Notwithstanding several specific references in the Consultation to the use of the Standardized Approach for Counterparty Credit Risk ("SA-CCR"), the Basel Committee apparently intends for exposures to securities financing transactions ("SFT") to be measured using an amended version of the haircut-based Comprehensive Approach, with more conservative volatility assumptions. This decision follows comments made by the Basel Committee in the final large exposure framework, that work was underway to develop a revised and presumably more risk-sensitive version of the Comprehensive Approach, including a possible 'equivalent non-internal models method'.⁴ This also follows outreach by the Board of Governors of the US Federal Reserve System ("FRB") to several US custody banks in the form of a quantitative impact study, on alternative methodologies for the measurement of exposures to SFT for purposes of pending rulemaking on single counterparty credit limits ("SCCL").

We are concerned that the approach adopted by the Basel Committee fails to consider the substantial limitations of the Comprehensive Approach in its existing and proposed form, thereby vastly overstating credit risk in agency-indemnified SFT and therefore the 'maximum possible loss' that a bank may incur. This has important implications for the ability of custody

⁴'Supervisory Framework for Measuring and Controlling Large Exposures', Basel Committee on Banking Supervision (April 2014), Paragraph 34.

banks to support access to pools of investment assets held by their institutional investor clients, used among other, to facilitate market liquidity and efficiency, meet growing demand for high-quality collateral in support of the centralized clearing of over-the-counter (“OTC”) derivatives and long-term investors access to low-risk, incremental returns. The resulting inevitable contraction of the securities lending market is unnecessary to meet the Basel Committee’s objectives and will have significant detrimental impacts on both financial markets and market participants.

Existing Credit Exposure Measurement

Custody banks have long provided agency securities lending services to their institutional investor clients under the active 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. These models were initially approved for use in securities lending and repurchase transactions by the FRB under Basel I. Similar methodologies have since been adopted by the Basel Committee and incorporated into various national prudential frameworks as part of both Basel II and Basel III. 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 also benefitted from significant multi-million dollar investments and extensive systems upgrades. As such, while we take no position on the Basel Committee’s proposal to remove Simple VaR as an option in the standardized approach for credit risk, we view these methodologies as an appropriate basis for the measurement of exposures to SFT in the context of the advanced approaches.

The Amended Comprehensive Approach

Unlike OTC derivatives transactions which are subject to measurement using the recently developed SA-CCR, the Basel Committee proposes to measure exposures to SFT using an amended version of the existing haircut-based Comprehensive Approach, with even more conservative volatility assumptions that result in a dramatic overstatement of credit risk. Indeed, as proposed, exposures to SFT would equal the difference between (i) the value of the securities lent, plus a risk-insensitive volatility factor, and (ii) the value of the collateral

accepted, less a risk-insensitive volatility factor. This proposed methodology suffers from several significant structural limitations.

First, while we acknowledge the Basel Committee's willingness to forgo some level of risk-sensitivity in favor of simplicity, the intended volatility factors are highly arbitrary and do not appear to reflect empirical considerations, such as industry experience during times of financial market stress. This includes the lack of recognition for 'flight to quality', where certain types of securities, such as equities and corporate bonds, would be expected to decline in value, whereas other 'safe' assets, such as US Treasury obligations would be expected to rise. Second, the proposed methodology provides no recognition for diversification within the lending or collateral portfolios, assuming at all times a positive and highly implausible correlation of 1.00. Similarly, the amended Comprehensive Approach does not recognize the correlation that exists between securities lent and collateral received, with market values assumed to move in opposite directions. This is based on the flawed assumption that all securities lent and all collateral received have a constant correlation of -1.00. Third, the intended methodology continues to provide very limited opportunities to net transactions, which is only allowed at the level of the individual security. Finally, the adjustment proposed for cross-border currency transactions (5.7% assuming a five business day holding period) overstates volatility for most currency pairs by a factor of almost two.

The result is a standardized measure of exposure for agency-indemnified SFT that is multiples higher than the 'maximum possible loss' a bank could sustain to a single counterparty. These issues are particularly pressing in non-US markets, where the use of equities and non-cash collateral in agency-indemnified SFT is common. A specific example of the substantial risk exposures produced by the proposed amended Comprehensive Approach can be found in the enclosed Annex 1 of our comment letter.

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 pension 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.

By dramatically overstating credit risk in agency-indemnified SFT, the Basel Committee's proposed methodology would serve to further entrench the standardized approach as the binding regulatory constraint for advanced approach US custody banks, due to the requirements of Section 171 of the Dodd-Frank Act. This will, in turn, trigger a further contraction of the already diminished securities lending market, with important negative implications for the financial system and the investor community. Estimates from industry

sources in the context of proposed rulemaking by the US FRB relative to SCCL, revealed a likely decline in securities lending transactions of 30% to 50% from already significantly reduced post-financial crisis levels.⁵ The impact of the Basel Committee's proposal is likely to be even more significant due to the revised volatility assumptions contained in the amended Comprehensive Approach and the far greater number of banks that will be impacted by the parallel effort to develop a standardized risk-based capital floor.

Moreover, the Basel Committee's intended methodology may paradoxically heighten credit concentration risk among banks by limiting the ability of smaller institutions, including stand-alone custody banks, 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 agency-indemnified SFT, 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 for Securities Lending Transactions

While we acknowledge and accept the view expressed in the Consultation that the standardized approach should not incorporate internal models in the measurement of credit exposures, we believe that it is essential for the Basel Committee to define an alternative non-internal model-based approach that more accurately reflects underlying risk in agency indemnified SFT. We note, in this respect, that the Basel Committee draws a useful distinction in its final leverage ratio standard between methodologies for agency-indemnified activities (current exposure) and principal activities (gross exposure). In our view, the treatment of agency-indemnified SFT is not unlike that of derivatives exposures, where well understood limitations in the 'current exposure method' led the Basel Committee to develop the far more risk-sensitive SA-CCR.

There are a number of alternative non-internal model-based approaches that the Basel Committee may wish to consider. The first, the 'regulatory input method', involves the use of a prescribed formula populated by a series of data elements provided by the supervisory community based on observable data that is relevant to SFTs. This includes the volatility of the lent security, the volatility of the collateral received, and the stressed correlation that exists between the lent security and the offsetting collateral, calibrated to a 99th percent confidence interval. Under this approach, the only data that a banking institution would independently provide are the value of lent securities and collateral received, thereby ensuring exposure calculations which are easily comparable across banks. Among the benefits of this approach is its inherent flexibility, including the capacity for the supervisory community to adjust

⁵ 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.

confidence levels and the ability to update parameters based upon changing market conditions. This approach can also be enhanced to reflect differences in exposures resulting from ‘right-way’ vs. ‘wrong-way’ risk. An example of the formula used in the regulatory input method can be found in the enclosed Annex 2 of our comment letter.

The second alternative, the ‘revised Comprehensive Approach’, involves replacing the current risk-insensitive haircut-based look-up table, with an updated multi-dimensional look-up table designed to reflect key factors in the measurement of exposures to agency-indemnified SFT. This includes the stressed correlation that exists between securities placed on loan and collateral received, the scope of diversification within the loan and collateral portfolios, and other key variables. This methodology is intended to be applied on a portfolio basis, taking into consideration applicable netting sets. Among the benefits of this approach is its ease of use, along with heightened transparency that facilitates comparability of capital outcomes across banks. As with the regulatory input method, this approach also addresses the impact of ‘right-way’ vs. ‘wrong-way’ risk. The specific look-up table that we recommend, including applicable haircuts for various loan-to-collateral pairs, is enclosed in Annex 3 of our comment letter.

Finally, and in view of the broad availability of economically equivalent OTC derivatives, the Basel Committee may wish to consider the development of an ‘SA-CCR type’ framework for exposures to agency-indemnified SFT. This approach involves the mapping of securities loan and collateral types to existing SA-CCR assets classes; specifically equity securities to equity derivatives, fixed income securities to interest rate and credit derivatives, and currency mismatch to foreign exchange derivatives. Under this approach, securities loans would be treated as a short derivatives exposure and collateral would be treated as a long derivatives exposure. Consistent with the current treatment of SFTs, the maturity factor would be set at 5 days for liquid securities and 20 days for illiquid securities. The exposure-at-default (“EAD”) formula would, in turn, be adjusted to reflect a zero RC, so that $EAD = \alpha * PFE$. Among the benefits of this approach is its improved risk-sensitivity and calibration on the basis of a methodology that has already been approved by the Basel Committee. Furthermore and as intimated above, this approach has the advantage of ensuring consistency in the treatment of SFT with economically equivalent derivatives, thereby averting the kind of arbitrage that would otherwise result from the presence of starkly different methodologies within the Basel Committee’s credit risk mitigation framework.

The importance of an alternative non-internal model-based solution for addressing the existing and proposed treatment of agency-indemnified SFT should not be underestimated. According to our analysis, the Basel Committee’s intended approach, including differences in counterparty risk weights, would produce exposures which are 40x to 50x greater than existing Simple VaR methodologies. This would decline to between 15x and 20x Simple VaR calculations using any of the alternative methodologies proposed. Although still quite conservative, these outcomes are not dissimilar to the outcomes observed in the context of the annual FRB stress test of US banks and are therefore generally acceptable as a standardized measure of credit risk.

We have presented the outlines of these and other possible approaches to various regulators globally, notably in the context of our work on the large exposure regime, and we would welcome the opportunity to do the same with the members of the Basel Committee Task Force on the Standardized Approach (“TFSA”). In the interim and in view of the substantial importance of this issue for global custody banks, we urge the Basel Committee to establish a specific supervisory work stream tasked with the development of an appropriately risk-sensitive, non-internal model-based alternative for use in the context of agency-indemnified SFT.

INVESTMENT FUND COUNTERPARTIES

The Basel Committee proposes to revise the current measurement of exposures to corporate entities by removing the reference to external ratings and the use of a flat risk-weight for unrated entities, in favor of a look-up table based upon a combination of revenue and leverage. The various categories of revenue in the look-up table begin at less than or equal to 5 million EUR and extend to greater than or equal to 1 billion EUR. In turn, the measure of leverage spans four buckets, ranging from 1x to 3x total leverage to negative equity. The assumption behind this methodology is that a corporate entity with high revenue and low leverage represents a lower risk of default vs. a corporate entity with lower revenue and high leverage. We are concerned that this approach is highly pro-cyclical, difficult to implement due to the lack of readily obtainable data, and is insufficiently responsive to the unique characteristics of various corporate exposures.

As proposed by the Basel Committee, corporate exposures are broadly defined to include ‘incorporated entities, associations, partnerships, proprietorships, trusts, funds and other entities with similar characteristics that do not meet the requirements of any other exposure class’.⁶ The corporate exposure category is therefore extremely heterogeneous and the Basel Committee notes that this approach may ‘not be appropriate for all types of corporates (e.g. funds) or for all jurisdictions’.⁷ Furthermore, it invites comment on ‘possible alternative risk-drivers or specific ways to improve the proposal’.⁸ In view of our particular custody bank business model, we believe that it is important to offer comment on the feasibility of the intended approach for exposures to investment fund counterparties.

Unlike traditional corporate entities in various industries, such as energy, health care, telecommunication, technology and insurance, investment funds have very limited and specifically defined commercial revenue streams. These are typically set at a small percent of a fund’s total assets and are distinct from investment returns which accrue directly to the underlying investor or beneficiary. Moreover, there are many types of fund structures that do

⁶ Basel Committee Consultative Document, page 10.

⁷ Basel Committee Consultative Document, page 11.

⁸ Basel Committee Consultative Document, page 12.

not have a commercial provider, such as a fund sponsor, and therefore do not generate revenue as the term is generally understood. This includes pension funds, which are established to provide income to beneficiaries in retirement and sovereign wealth funds, which are designed to manage national financial resources for existing or future generations of citizens. As such, while we agree that the amount of leverage is a relevant consideration in the assessment of exposure to an investment fund counterparty, we believe that the use of revenue is inappropriate and would result in a highly misleading understanding of credit risk.

More generally, we also believe that there is value in the development of an approach for corporate exposures that makes use of the ‘investment grade vs. non-investment grade’ framework found in US prudential regulation. As such, we suggest the introduction of a two-step approach for exposures to investment fund counterparties. The first would involve an assessment of whether the exposure to the investment fund represents an investment grade exposure. This involves a determination of whether the entity ‘has adequate capacity to meet (its) financial commitments for the projected life of the exposure’, with the term ‘adequate capacity’ further defined as a situation in which the risk of default is low and the full and timely repayment of the exposure is expected.⁹ While this determination will involve some element of qualitative judgment, supervisory authorities can and should establish rigorous standards to help inform these judgments, thereby combining strong regulatory oversight with internal credit risk assessments. For exposures to investment fund counterparties which are categorized as investment grade, we suggest the use of a uniform risk-weight of 60%, which is equivalent to the lowest risk-weight proposed by the Basel Committee for corporate exposures.

If on the other hand, the exposure to the investment fund counterparty is non-investment grade, we suggest the use of a revised look-up table combining two risk drivers: leverage and liquidity. In order to mitigate operational complexity, we believe that banking institutions should be able to determine the presence of leverage based on information contained in the fund prospectus, investment guidelines or other similar constitutive documentation. As for liquidity, we believe that a useful and readily accessible proxy involves the hierarchy of assets prescribed in both US generally accepted accounting principles (FAS 157) and international financial reporting standards (IFRS 13). More specifically, the look up table would classify the relative liquidity of the investment fund’s assets and unencumbered cash, using one of three levels. The first, Level 1 assets, are those which are actively traded in financial markets and which have observable market prices. The second, Level 2 assets, are those that do not have an observable price, but have other measurable inputs, such as quoted prices for similar investments or interest rate and credit risk metrics. The third, Level 3 assets, are those which do not have observable inputs and therefore are valued on the basis of assumptions and estimations, often provided by the fund manager.

⁹ ‘Final Rule - Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Capital Adequacy, Transition Provisions, Prompt Corrective Action, Standardized Approach for Risk-Weighted Assets, Market Discipline and Disclosure Requirements, Advanced Approaches Risk-Based Capital Rule and Market Risk Capital Rule’, Board of Governors of the Federal Reserve System, Federal Register, Volume 78, Number 198, page 62165.

Given existing constraints in obtaining many of the data elements that would be required to operationalize this approach and also the need to properly prepare market participants for evolving regulatory expectations, we recommend a lengthy implementation timeline extending over a period of two to three years. As for calibration, we suggest the range of risk-weights proposed by the Basel Committee for corporate exposures, or between 60% and 130%. To the extent that it would be helpful to the TFSA, we are happy to expand upon this approach in a subsequent meeting or correspondence.

UNFUNDED COMMITMENTS TO INVESTMENT FUNDS

Notwithstanding the recent decision to amend the Basel III leverage ratio to include a more granular series of CCFs for unfunded commitments based upon length to maturity (i.e. 20% for original maturities of up to one year and 50% for original maturities of more than one year), the Basel Committee is now proposing to discard this framework in the standardized approach for credit risk and replace it with a uniform CCF of 75%.¹⁰ The stated logic for this change is to ensure consistency with the parameters found in the foundation internal ratings based (“IRB”) approach. While we recognize that one of the goals of the Basel Committee is to improve the harmonization of parameters in the standardized and IRB approaches, we believe that this change is unwarranted and that it contradicts the even greater imperative of ensuring appropriate risk-sensitivity in the measurement of regulatory capital. Indeed, we believe that the intended approach will result in a dramatic overstatement of risk in various types of value-added commitments. In the case of custody banks, this includes the highly punitive treatment of committed liquidity/ redemption facilities provided to regulated funds, such as US mutual funds, EU UCITS and other similar foreign equivalents.

Regulated funds are structured for sale to the retail investor community and are governed by detailed transparency, asset quality and diversification requirements. In addition, 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%. As such, regulated funds have limited and well-defined credit needs. They are also subject to ongoing supervision.

Custody banks provide committed liquidity/ redemption facilities to regulated funds on contractual terms to accommodate routine day-to-day operational matters. This includes unanticipated movements of cash, client investment activities and the payment of management fees and other expenses. Committed liquidity/ redemption facilities to regulated

¹⁰ ‘Basel III Leverage Ratio Framework and Disclosure Requirements’, Basel Committee on Banking Supervision (January 2014), page 19.

funds therefore play an important role in ensuring the efficient operation of financial markets. If custody banks, such as State Street, were subject to significant restrictions in their ability to offer such facilities to their regulated fund clients due to poorly-calibrated credit risk-parameters, this would necessitate special operational processes that would heighten potential transaction risk, increase investor costs and disrupt market efficiencies.

Committed liquidity/ redemption facilities to regulated funds 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. As a result, our experience is that committed liquidity/ redemption facilities provided to regulated funds represent limited credit risk and are unlikely to experience significant draw-downs, even during periods of financial market stress.

Indeed, an analysis of utilization rates for committed liquidity/ redemption facilities provided to regulated funds by State Street since 2007 reveal incremental draw-down rates substantially below 10%, including at the height of the financial crisis. This information has been provided, among others, to the Basel Committee in the context of its work on the Basel III Liquidity Accord and is reflected in the use of different draw-down rates for various committed facilities in the Liquidity Coverage Ratio.¹¹ We are happy to share the details of our utilization rates for our regulated investment fund counterparties with the TFSA on a confidential basis, should this prove of interest.

More generally, we believe that length to maturity is an important consideration in determining the relative credit risk of an unfunded liquidity/ redemption line and that it should therefore not be discarded simply as a means of improving comparability with foundation IRB. As such, we recommend that the Basel Committee maintain the current distinction which exists in the standardized approach for credit risk for commitments with original maturities of up to one year (20%) and commitments with original maturities of more than one year (50%). Alternatively, we recommend that the Basel Committee incorporate within the revised standardized approach for credit risk, a specific and more granular CCF for committed liquidity/ redemption facilities to regulated funds. Consistent with the approach adopted for trade finance commitments, we recommend the use of a CCF of 20%. This reflects the essential role which these low-risk obligations play in promoting the smooth and efficient operation of financial markets, and therefore the importance of a standardized methodology that properly accounts for their inherent level of risk.

¹¹ ‘Basel III: The Liquidity Coverage Ratio and Liquidity Risk Monitoring Tools’, Basel Committee on Banking Supervision (January 2103), paragraph 131.

CONCLUSION

Thank you once again for the opportunity to comment on the important matters raised within this Consultation. To summarize, while we recognize the growing emphasis of the supervisory community on improving the design and calibration of standardized measures of capital, and while we acknowledge the inherent challenges in developing an approach that can be broadly applied across banks of various size, scope and sophistication, we are concerned that several of the revisions proposed by the Basel Committee in respect of credit risk do not properly account for the particular characteristics of the custody bank business model. This includes the intended treatment of agency-indemnified SFT, the methodology for measuring exposures to investment fund counterparties and the prescribed CCF for unfunded commitments to regulated funds.

We therefore recommend a series of adjustments to several aspects of the proposed framework, designed to improve risk sensitivity and therefore avoid broad and unwarranted disruptions to our stable and highly-valued industry business model. More specifically, we strongly urge the development of a revised, non-internal model-based approach for the measurement of exposures to agency-indemnified SFT, using either a series of prescribed supervisory inputs within a common industry formula (the regulatory input method), a revised multi-dimensional haircut-based look-up table that appropriately captures correlation, portfolio diversification and other similar factors (the revised Comprehensive Approach), or a modified version of the SA-CCR. In addition, we suggest the introduction of a two-step approach for exposures to investment fund counterparties involving an assessment of whether the exposure is to an investment grade entity, and if not, the use of a fund specific look-up table combining both leverage and liquidity. Finally, we urge either the maintenance of the existing CCFs for unfunded commitments based on length to maturity of the commitment, or the introduction of a specific CCF for committed liquidity/ redemption lines to regulated funds.

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

ANNEX 1

Example of the Impact of the Amended 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 ($\alpha + \beta m$).

As an example, the combined risk of a main index equity lent and a main index equity received as collateral would therefore be $(\alpha_1 + \beta_1 m) - (\alpha_2 + \beta_2 m)$, which equals the square root of $((\alpha_1)^2 + (-\alpha_2)^2 + 2(\alpha_1)(-\alpha_2)(\rho)) + (\beta_1 - \beta_2)m$.

Taking conservative market-based assumptions the risk of such a combination would then be the square root of $((2.1)^2 + (-3.2)^2 + 2(2.1)(-3.2)(-1.00)) + ((.8 - .7) * 14.14) = \mathbf{6.78}$.

The market-based assumptions are:

$$\alpha_1 = 2.1\%$$

$$\alpha_2 = 3.2\%$$

$$\rho = -1.00 \text{ (this is a most conservative estimate, thereby providing a worst case outcome)}$$

$$\beta_1 = .8$$

$$\beta_2 = .7$$

$$m = 14.14\%$$

The proposed haircut-based methodology does not recognize the offsetting benefit of the β s and effectively adds them together, thereby deriving a significantly higher risk of the combined position $(14.14 + 14.14) = \mathbf{28.28}$.

ANNEX 2

REGULATORY INPUT METHOD

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

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.

ANNEX 3

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;

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