



State Street Corporation

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

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

Telephone: 617.664.8673
Facsimile: 617.664.9339
smgavell@statestreet.com
www.statestreet.com

March 17, 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

Consultative Document – Identification and Measurement of Step-in 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 (“Committee”) regarding ‘step-in risk’. Headquartered in Boston, Massachusetts, State Street 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 asset under management (“AUM”) as of December 31, 2015, State Street operates in 29 countries and in more than 100 geographic markets. State Street provides investment management services through its asset management arm, State Street Global Advisors (“SSGA”), which is one of the world’s largest bank-owned asset managers. Our comments within this letter focus solely on the application of the Committee’s ‘step-in risk’ proposal to the asset management activities of banks, specifically the sponsorship of investment funds.

As defined by the Committee, ‘step-in risk’ is ‘the risk that a bank may provide financial support to an (unconsolidated) entity beyond or in the absence of any contractual obligations, should the (unconsolidated) entity experience financial stress,’ in order to protect the bank from potentially adverse reputational risk.¹ The Consultation proposes a series of primary and

¹ ‘Consultative Document on the Identification and Measurement of Step-in Risk’, Basel Committee on Banking Supervision (December 2015), page 1.

secondary indicators for the identification of unconsolidated entities that could create ‘step-in risk,’ along with potential new regulatory capital requirements to address such risks.

State Street and SSGA strongly oppose the inclusion of bank-owned asset managers and sponsored funds within the scope of the Committee’s ‘step-in risk’ proposal. We do not believe that the Committee has adequately evaluated or documented the potential for ‘step-in risk’ in such funds, particularly for heavily regulated and widely held investment fund products, such as United States (“US”) mutual funds or European Union Undertaking for Collective Investments in Transferable Securities (“EU UCITS”). With the exception, as noted in the Consultation, of certain Money Market Funds (“MMF”), there is no history of financial support for sponsored funds and therefore no evidence of market or investor expectation that a bank-owned asset manager will ‘step-in’ to cover investment losses or otherwise support an investment fund. The misapplication of a potential capital charge to address a non-existent ‘step-in risk’ for bank sponsored funds will disrupt competition in the financial markets and create unnecessary costs for bank-owned asset managers.

Our primary concerns with the Committee’s proposal centers on: (i) the use of inappropriate indicators for the identification of ‘step-in risk’ in sponsored funds, (ii) the lack of recognition for the broad range of legal, regulatory and contractual mandates which limit a bank’s ability to provide financial support to such funds, and (iii) undue reliance on regulatory capital requirements as a means of addressing potential ‘step-in risk’ concerns. We therefore respectfully urge the Committee to remove bank-owned asset managers and sponsored funds from the scope of the proposed ‘step-in risk’ regime for the reasons more fully described below.²

INAPPROPRIATE INDICATORS FOR IDENTIFYING INVESTMENT FUNDS WITH “STEP-IN RISK”

The Committee acknowledges that the primary driver of ‘step-in risk’ is the concern that the weakness or failure of an unconsolidated entity, such as a sponsored fund, could have negative implications for a bank, and it correctly distinguishes between reputational risk and operational risk, the latter of which is already addressed within the Committee’s regulatory capital framework and local prudential standards.³

In order for such reputational risk to be relevant, however, an unconsolidated entity must be engaged in an activity which creates an expectation of support from the bank. As previously noted, with the exception of certain MMFs as described in the Consultation⁴, there is simply no expectation that a fund sponsor – whether a bank or non-bank – will provide support to

² We note that there is considerable overlap between the issues raised in the Consultation with respect to asset management and the Financial Stability Board’s ongoing review of asset management activities.

³ ‘Consultative Document on the Identification and Measurement of Step-in Risk’, Basel Committee on Banking Supervision (December 2015), page 9.

⁴ Which, as the Committee describes, have been or will be addressed by new regulations.

address financial losses. Since the entire purpose of an investment fund is to permit investors to obtain exposure to selected market segments or investment strategies, the expectation is that the investor rather than the fund sponsor will suffer from investment losses and will benefit from investment gains. As such, for the vast majority of investment funds, there is simply no credible reputational risk for the fund sponsor, since there is no expectation in the market of sponsor support. This has been true even in periods of tremendous financial market stress and declining asset values, such as in mid-2008 when the S&P 500 lost over a third of its value, but no fund sponsor provided, or was expected to provide, support to investment funds benchmarked to the S&P 500, in order to offset these losses.

The Consultation does not consider in any detail the potential reasons for ‘step-in risk’ in an investment fund, and proposes an identification regime based on the concept of ‘sponsorship.’ Entities that are sponsored by a bank are presumed to create ‘step-in risk’. As defined, sponsorship includes a bank that ‘manages or advises’ an unconsolidated entity, including a sponsored fund, regardless of the presence of any other indicator of control, such as the provision of a credit or liquidity facility. Since, by definition, asset management involves the management of financial assets in accordance with an entity’s prescribed investment strategy and guidelines, the Committee’s approach has the practical effect of including within the scope of the conceptual framework any and all bank-sponsored funds, even those which by virtue of their structure have no inherent potential for ‘step-in risk.’ As an example, the intended definition of sponsorship would capture passively managed funds which are designed to track the performance of a broad-based market index, such as the S&P 500 or the MSCI Europe, where there is no presumption of financial performance beyond the performance of the market itself.

Furthermore, the conceptual framework proposed by the Committee has been designed in a manner which presupposes the existence of ‘step-in risk’ in all sponsored fund relationships and therefore the uniform need for prudential redress. This is most evident in section 4.2 of the Consultation on the ‘mapping of primary indicators with measurement approaches’, where the only alternatives specified for a sponsored fund where a bank has decision-making authority but does not otherwise provide credit or liquidity support (in other words the indicator methodology which defines the vast majority of sponsored fund relationships), is full regulatory consolidation or the use of a conversion factor to translate an amorphous off-balance sheet risk into a risk-based capital charge.⁵ We believe that this approach is unnecessarily prejudicial in its assessment of bank-owned asset managers and sponsored funds, and ignores industry experience during the financial crisis when, as previously noted, the vast majority of bank-sponsored funds received no such support.

⁵ ‘Consultative Document on the Identification and Measurement of Step-in Risk’, Basel Committee on Banking Supervision (December 2015), pages 22-23.

LACK OF RECOGNITION OF EXISTING MITIGANTS TO “STEP-IN RISK” FOR INVESTMENT FUNDS

The Committee acknowledges in its Consultation that, in some cases, there may be mitigants to ‘step-in risk,’ in various national jurisdictions that would prevent a bank from providing financial support to an unconsolidated entity, such as a sponsored fund, and that these mitigants can be used by national supervisory authorities to preemptively limit the scope of the ‘step-in risk’ assessment. Referred to by the Committee as ‘collective rebuttals’, these mitigants include the Volcker Rule, which prohibits banks in the US from providing financial support to covered funds, including hedge and private equity funds, where the bank either directly or indirectly serves as an investment manager, investment advisor or sponsor. While we welcome the Committee’s acknowledgment that there may be certain categories of investment funds that should not be subject to review for potential ‘step-in risk’, we believe that the ‘collective rebuttal’ standard is defined far too narrowly and therefore does not adequately address the extremely broad presumption in the Consultation that sponsored funds create inherent ‘step-in risk’.

In our view, this overreach reflects several interrelated factors. First, the Committee does not comprehensively describe in its Consultation the range of legal mandates in national jurisdictions, such as the US, which substantially limit the ability of a bank to provide financial support to a sponsored fund. This includes Section 23A of the Federal Reserve Act of 1913 (as amended) which limits a bank’s ‘covered transactions’ with any single affiliate, including a sponsored fund, to no more than 10% of the bank’s capital stock and surplus, and further limits ‘covered transactions’ with all affiliates combined, including sponsored funds, to no more than 20% of the bank’s capital stock and surplus. ‘Covered transactions’ are defined in the Federal Reserve Act to include, among other, the provision of a loan or extension of credit to an affiliate, the purchase of assets from an affiliate, or the issuance of a guarantee, acceptance, or letter of credit to an affiliate. Furthermore, Section 23B of the Federal Reserve Act requires that ‘covered transactions’ between a bank and its affiliates be executed at ‘arm’s length, on market terms’, while also expanding the definition of ‘covered transactions’ to include any payment of funds to the affiliate.

Second, the Committee has explicitly chosen to limit the application of the ‘collective rebuttals’ concept to mandates which are enforceable by law. While we recognize the need for a rigorous standard with broad applicability across national jurisdictions, this approach overlooks the impact of regulatory guidelines and supervisory expectations which define the relationship between a bank and its sponsored funds, and which cannot in practice be ignored by a bank without the risk of severe financial and/or commercial sanction. As an example, in 2004 the US prudential regulators issued interagency guidance which places substantial restrictions on the ability of a bank to offer support to a sponsored fund.⁶ This guidance alerts banks to the safety-and-soundness implications of potential financial support, along with a description of the legal

⁶ ‘Interagency Policy on Banks and Thrifts Providing Financial Support to Funds Advised by the Banking Organization or its Affiliates’, Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Office of Thrift Supervision and the Federal Deposit Insurance Corporation (January 5, 2004).

impediments to such support. Furthermore, it emphasizes three core principles: namely that a bank (i) should not inappropriately place its resources and reputation at risk for the benefit of a sponsored fund's investors and creditors, (ii) should not violate the limits and requirements of Section 23A and Section 23B of the Federal Reserve Act, or other legal mandates and supervisory conditions which may be imposed by the US prudential regulators, and (iii) create any expectation that a bank will support its advised or sponsored funds.

Similarly, senior management is expected to notify and consult with the appropriate US prudential regulator before providing material financial support, an expectation which has broadly been interpreted by the industry as a requirement for advanced consent. As such, a bank cannot in practice provide financial support to a sponsored fund without first consulting with the appropriate US prudential regulator to determine whether the intended actions raise supervisory concerns, including impacts on regulatory capital, accounting consolidation, client expectations and credit rating agency view of underlying risk.

Furthermore, the Committee's approach does not permit consideration of the explicit commitments made by banks in the context of their recovery and resolution planning efforts and annual stress testing requirements, not to provide financial support to a sponsored fund or other unconsolidated entity.⁷ These commitments are driven by specific regulatory mandates emanating from the financial crisis, including measures prescribed in the Dodd-Frank Wall Street Reform and Consumer Protection Act, which are designed to enhance the resiliency of banks and improve their resolvability in the event of insolvency. Although not explicitly enforceable as a matter of law, non-compliance with any of these regulatory mandates carry implications for banks which are often as severe, and should therefore be given equal deference by the Committee in any assessment of potential 'step-in risk'.

Third, the Committee has also chosen to pre-emptively exclude from the definition of 'collective rebuttals' any restrictions on the provision of financial support to a sponsored fund or other unconsolidated entity, which has been agreed to by a bank as a matter of contract law. Consistent with our above comments, we believe that this approach is far too restrictive, and as such overlooks the substantial importance of contract law in documenting and defining the relationship between a bank and its asset management activities, and therefore the scope of potential unresolved 'step-in risk'. This is in large part a matter of regulatory fairness since banks should be given the opportunity to respond to the perceived presence of a regulatory gap with appropriate mitigants, without the need for formal legal or regulatory intervention which is not always practical or feasible. Indeed, absent the ability to address perceived instances of 'step-in risk' via contract law, bank-owned asset managers will be placed at a substantial commercial disadvantage relative to non-bank owned assets managers from which there would be no practical means of redress.

⁷ The Board of Governors of the Federal Reserve System Comprehensive Capital Analysis and Review (CCAR) program.

Fourth, while the Committee acknowledges that certain measures have been implemented since the financial crisis which narrow the scope of potential ‘step-in risk’ in asset management activities, we believe that the importance of these measures is broadly understated, thereby resulting in a conceptual framework that is unnecessarily expansive in its view of residual risk. More specifically, this centers on the implications of new rules adopted by the US Securities and Exchange Commission (“SEC”) regarding the operation of MMFs, which as previously noted, is the only type of investment fund with a documented history of fund sponsor support.

These new rules, which are effective in October 2016, introduce a floating net asset value requirement for all institutional prime and municipal MMFs, permit the imposition of liquidity fees and redemption gates in the event of a decline in amounts of available liquid assets, and introduce enhanced portfolio diversification, reporting and disclosure mandates. Together, these requirements effectively eliminate the concept of an implicit floor on the value of a MMF and therefore the primary rationale for fund sponsor support.⁸ As emphasized by SEC Chairman Mary Jo White, these ‘reforms fundamentally change the way that MMFs operate’, in a manner which in our view largely addresses the historical expectations of investors of implied financial support.⁹

While the deficiencies with the Committee’s proposed rebuttals are serious, we view them as symptoms of the broad overreach of the Consultation with respect to bank-owned asset managers and sponsored funds, rather than as technical issues that could be adjusted to improve the proposed regime. We therefore do not believe that it is either possible or desirable to attempt to revise the conceptual framework to capture residual risks in asset management activities or funds under management.

UNDUE EMPHASIS ON CAPITAL REQUIREMENTS AS MITIGANT FOR “STEP-IN RISK”

As emphasized above, we strongly oppose the inclusion of bank-owned asset managers and sponsored funds within the scope of the Committee’s proposed ‘step-in risk’ framework on the basis that the Committee has not established the reputational motivation for banks to provide support to such entities, while also proposing an identification scheme based on concepts of sponsorship and the presumption of ‘step-in risk’ which are inappropriate for these activities.

Furthermore, we are equally concerned with the prudential measures envisioned by the Committee for such activities. Notwithstanding the assertion that no decision has been made as to how the conceptual framework will be reflected within the regulatory capital framework, section 5.4.2 of the Consultation on ‘specific approaches to asset management entities and

⁸ ‘Final Rule - Money Market Fund Reform; Amendments to Form PF’, United States Securities and Exchange Commission, Federal Register (August 14, 2014), Volume 79, Number 157, page 47736.

⁹ ‘Press Release: SEC Adopts Money Market Fund Reform Rules’, United States Securities and Exchange Commission (July 23, 2014).

funds' envisions a Pillar I approach in which banks would face a regulatory capital charge based upon a percentage of AUM.¹⁰

Mandating a new capital requirement is simply inappropriate as a means of addressing potential concerns regarding the presence of 'step-in risk' in bank-owned asset managers. The Committee cites numerous examples of existing or emerging policy responses to address possible 'step-in risk' in asset management activities and sponsored funds, including the ring-fencing initiative in the United Kingdom, the US Volcker Rule, the EU and US MMF reforms, and new US SEC liquidity risk management program requirements. None of these initiatives are capital rules, and all are aimed toward specific asset management activities which policymakers have identified as either inappropriate for banks (*i.e.* the Volcker Rule) or as contributing to systemic risk (*i.e.* MMF reforms). By contrast, the Committee's proposed approach focuses solely on the establishment of a new regulatory capital framework.

We strongly object to this capital-only approach to the treatment of potential 'step-in risk' in bank-owned asset managers. Both the full consolidation and the conversion approach suggested in the Consultation are extraordinarily blunt instruments, arbitrarily assigning a potentially enormous amount of credit risk to a bank-sponsored fund, regardless of the structure, investment strategy or risk profile of the fund. Indeed, the Consultation provides no data or other support for the proposed calibration of the conversion factor at 1% of AUM. The result is a highly risk-insensitive regulatory capital framework that would uniformly apply to all sponsored funds, even in the absence of any market expectation or history of financial support. This lack of risk sensitivity will, in turn, have the perverse effect of discouraging banks from offering the types of low-risk, highly transparent passive investment strategies which are central to the accumulation of retirement income and other investment savings in the global financial system.

CONCLUSION

Thank you once again for the opportunity to comment on the important matters raised within this Consultation. To summarize, we are strongly opposed to the conceptual framework proposed by the Committee for the identification and measurement of 'step-in risk' as applied to bank-owned asset managers and sponsored funds.

First, we do not believe that the Committee has adequately evaluated, explained or demonstrated the presence of a regulatory concern which would warrant additional prudential action, particularly when the actions proposed by the Committee would only apply to bank-owned asset managers and therefore create competitive inequities in the market. Second, we do not believe that the proposed conceptual framework is 'fit for purpose' due to its highly

¹⁰ 'Consultative Document on the Identification and Measurement of Step-in Risk', Basel Committee on Banking Supervision (December 2015), page 26.

expansive and prejudicial view of the relationship between a bank and its sponsored funds. Third, we believe the Committee has taken far too narrow of a view on the substantial range of regulatory, legal and contractual mandates which limit the ability of a bank to provide financial support. Finally, even if the Committee determines that there is a basis for additional regulatory scrutiny of 'step-in risk' for bank-owned asset managers, we strongly oppose the capital-only regime proposed in the Consultation.

We therefore recommend that the Committee remove asset management activities and funds under management from the scope of its work, or alternatively that the proposed framework be reconstituted as a set of guidelines to assist supervisors in their assessment of potential 'step-in risk' in bank-owned asset managers, without the presumption of any specific capital consequence.

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

Sincerely,

A handwritten signature in black ink, appearing to read 'Stefan M. Gavell', written in a cursive style.

Stefan M. Gavell