



State Street Corporation

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Secretariat of the Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel
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Consultative Document: Reducing Variation in Credit Risk-Weighted Assets – Constraints on the Use of Internal Model Approaches

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 advanced internal-ratings based (“A-IRB”) approach for determining required amounts of credit risk capital. Headquartered in Boston, Massachusetts, State Street is a stand-alone custody bank that 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 \$26.8 trillion in assets under custody and administration and \$2.3 trillion in assets under management as of March 31, 2016, State Street operates in 30 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-Frank Wall Street Reform and Consumer Protection 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 March 31, 2016, our Basel III advanced approach common equity Tier 1 (“CET1”) ratio was 12.3% and our Basel III standardized approach CET1 ratio was 12.5%.

The Basel Committee proposes in its consultation several far-reaching changes to the A-IRB framework, specifically (i) the elimination of the internal-ratings based (“IRB”) approaches for exposures to banks, other financial institutions, large corporates and equities; (ii) the adoption of model parameter floors for exposures where the use of the IRB approaches remains permissible; and (iii) the introduction of greater specification in the internal model parameter estimation practices of banks. The purpose of these revisions is to reduce the complexity of the prevailing regulatory capital framework for credit risk, address excessive variability in risk-weighted assets (“RWA”) among banks and improve the comparability of capital outcomes on an industry-wide basis. This consultation is part of a broader review of the Basel III framework, which the Basel Committee intends to complete by year-end 2016.

State Street recognizes the growing emphasis which the supervisory community places on the standardized assessment of credit risk and we do not oppose the introduction of greater standardization within various components of the A-IRB framework in support of the Basel Committee’s objectives. Nevertheless, this requires the presence of a standardized alternative which properly reflects the risk profile of key exposure types and which provides for a reasonable estimation of credit risk. This does not currently apply to investment funds which are not treated by the Basel Committee as a distinct exposure type, falling instead within the general category of corporate exposures. The corporate exposure category is broadly defined in the Basel III framework 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.’¹

This ‘catch-all’ approach results in a standardized methodology which fails to account for the particular characteristics and risk profile of investment funds, and which therefore substantially overstates credit risk. Indeed, using the proposed A-IRB methodology for large corporate exposures and a conservative view of the still to be finalized standardized approach for credit risk, we estimate a three-fold increase in the RWA for our investment fund exposures when compared to the existing A-IRB approach. This outcome is clearly at odds with the Basel Committee’s stated intention ‘not to significantly increase overall capital requirements’ in its review of the Basel III framework.² Moreover, this substantial increase in RWA has important implications for the ability of custody banks, such as State Street, to provide cost-effective services to their institutional investor clients and therefore the ability of individual investors to accumulate, whether directly or indirectly, sufficient amounts of retirement income and other long-term savings.

¹ ‘Consultative Document; Revisions to the Standardized Approach for Credit Risk’, Basel Committee on Banking Supervision (December 2014), Section 2.2, page 10.

² ‘Consultative Document: Reducing Variation in Credit Risk-Weighted Assets – Constraints on the Use of Internal Model Approaches, Basel Committee on Banking Supervision (March 2016), (hereinafter referred to as the ‘Basel Committee Consultation’), page 2.

As such, we strongly recommend that the Basel Committee defer the decision to remove the use of the A-IRB approach for the measurement of exposures to investment funds and that it establish a dedicated work stream tasked with developing an alternative and appropriately risk-sensitive standardized framework for such funds, distinct from the general category of corporate exposures. Once completed, the Basel Committee should then use this revised framework as the basis for determining whether to proceed with the abandonment of the A-IRB approach for the measurement of exposures to investment funds in favor of a standardized alternative.

THE CUSTODY BANK BUSINESS MODEL

Custody banks, such as State Street, employ a highly specialized business model focused on the provision of operational services to institutional investor clients, rather than the generation of yield from credit risk assets. These clients, which include asset owners, asset managers, official institutions and insurance companies, contract with custody banks to ensure the proper safekeeping of their investment assets, as well as the provision of a broad range of related financial services. These services include: 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. The importance of financial services to the custody bank business model can be seen in the large amount of revenue derived from fee-related activities. As an example, in Q1 2016 fee revenue comprised 79.3% of State Street's total revenue.

Furthermore, the stand-alone custody banks have balance sheets which are constructed differently than other banks with extensive retail, commercial and investment banking operations. Indeed, the custody bank balance sheet is liability driven and expands not through asset growth, but through the organic development of client servicing relationships that, over time, translate into increased volumes of highly stable deposits. These deposits, rather than various sources of wholesale funding, comprise the largest part of the custody banks' liabilities. For instance, as of Q1 2016, client deposits made up more than 76% of State Street's total balance sheet. In turn, these highly stable deposits are used to fund the purchase of large and well-diversified portfolios of investment assets which generate conservative amounts of net interest revenue. Importantly, custody banks acquire deposit liabilities as a direct result of the financial services they provide. In other words, the cash deposits that come on to the custody bank balance sheet, and which are used to purchase high-quality investment assets, are driven by customer-related needs and not by the custody banks' financing decisions.

We appreciate the opportunity to offer insight relative to the implications of the Basel Committee's consultation on our role as a custodial entity, a role that is widely understood by the market and by the supervisory community as providing important benefits for the safety of client assets and the stability of the financial system. Our intention with this letter is to highlight

the issue raised by this consultation relative to the treatment of exposure to investment funds. In addition, we request clarification regarding the intended methodology for the measurement of exposures to agency-indemnified securities financing transactions (“SFT”), where custody banks play a crucial role in supporting market access to pools of investment assets held by their institutional investor clients. Agency-indemnified SFTs are used to enhance liquidity, reduce volatility, improve price discovery, address settlement fails and facilitate the exchange of collateral in support of various financial market activities.

REGULATORY CAPITAL FRAMEWORK FOR INVESTMENT FUNDS

Categorization of Investment Funds

As previously noted in our comment letter, custody banks such as State Street are uniquely focused on the provision of financial services to institutional investor clients. This centers on the safekeeping and administration of investment assets, and includes access to deposit accounts needed to support day-to-day transactional activities in diversified portfolios of investment assets. Essentially, custody banks provide the equivalent of checking accounts for institutional investors, used to buy or sell investment securities, along with the movement of cash resulting from these investment activities. Making it possible for clients to hold cash on deposit in various jurisdictions, and to be able to freely direct the movement of such cash, is therefore a central feature of the traditional custody function. In this way, custody banks play a narrow, but critical, role as the ‘nuts and bolts’ of the financial system, helping to facilitate the efficient operation of global investment activities. Indeed, it is difficult to imagine that institutional investor clients could function without custody banks, through which they safely and securely manage their safekeeping, asset administration and cash related needs.

The custody bank client base is diverse and includes regulated investment funds, such as US mutual funds (“40 Act Funds”), European Union (“EU”) Undertakings for Collective Investments in Transferable Securities (“UCITS”) and other similar national equivalents; alternative investment funds, including hedge and private equity funds; corporate and public retirement plans; sovereign wealth funds; insurance company accounts; charitable foundations and endowments. In many cases, the use of a custody bank is a function of the prevailing regulatory regime, such as the requirements which apply to 40 Act Funds under the Investment Company Act of 1940, to EU UCITS under the UCITS IV Directive, and to EU alternative investment funds under the Alternative Investment Fund Managers Directive (“AIFM Directive”). In other cases, the use of a custodian reflects well-established client preference to hold and to manage investment portfolios with banking entities which are subject to stringent prudential requirements and regulatory oversight. State Street is a leading provider of custody services to

regulated investment funds, with a market share of 58% for '40 Act Funds, 15% for Luxembourg-domiciled UCITS and 29% for Ireland-domiciled UCITS.³

From our perspective, the simplest and most logical way to structure a regulatory capital framework for investment funds is to divide such funds into two broad categories: regulated investment funds and non-regulated investment funds. While the term 'non-regulated' is somewhat misleading since it implies a complete absence of regulation for certain categories of funds when in fact all funds are subject to at least some level of regulatory scrutiny, this approach is broadly consistent with the common understanding of the universe of investment funds and the general design of various national regulatory frameworks. As an example, in the US there is a broad distinction drawn between investments funds which are registered with the Securities and Exchange Commission ("SEC"), such as '40 Act Funds, and unregistered funds, such as hedge and private equity funds, which are required to file with the SEC an annual Form PF disclosure.⁴ Similarly, the EU draws a distinction between 'harmonized funds', which are subject to regulation under the UCITS IV Directive, and 'non-harmonized funds', which are regulated under the AIFM Directive.⁵ From our perspective, regulated investment funds are best defined as encompassing '40 Act Funds, EU UCITS, other national equivalents (e.g. United Kingdom Non-UCITS Retail Schemes), and various investment funds managed to a comparable regulatory standard.⁶ As for non-regulated funds, these would include hedge funds, private equity funds, infrastructure funds, commodity funds, real estate funds, and any other fund with similar characteristics that do not meet the definition of a regulated fund.

These two broad categories of investment funds would, in turn, be subject to two different standardized risk weights consistent with their respective structure, as well as their capacity to trigger systemic risk within the banking industry. They would also be subject to two different credit conversion factors ("CCF") for undrawn commitments. This is intended to reflect the limited credit risk posed by regulated investment funds, including a *de minimus* historical loss experience which is substantially lower than the historical loss experience of regulated banks. Indeed, State Street has never experienced a credit loss on an exposure to a regulated

³ As of December 31, 2015, State Street provided investment services to 58% of all '40 Act Funds, representing 40% of total '40 Act Fund assets under custody and 44% of total '40 Act Funds under administration.

⁴ Under the US Liquidity Coverage Ratio final rule, non-regulated investment funds are defined as 'any hedge fund or private equity fund whose investment adviser is required to file SEC Form PF (Reporting Form for Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors), other than a small business investment company as defined in Section 102 of the Small Business Investment Act of 1958.'

'Liquidity Coverage Ratio: Liquidity Risk Measurement Standards', Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, and Federal Deposit Insurance Corporation, Federal Register, Volume 79, Number 197 (October 10, 2014), page 61526.

⁵ 'Non-harmonized funds' are defined under the AIFM Directive as any fund not subject to regulation under the UCITS Directive, or 'hedge funds, private equity funds, infrastructure funds, commodity funds and real estate funds'. Impact Assessment: Directive of the European Parliament and of the Council on Alternative Investment Fund Managers, European Commission (April 30, 2009), page 4.

⁶ Although not directly addressed within our comment letter, this category would also include private and public retirement plans which are subject to a rigorous and well-established body of regulation, such as the Employee Retirement Income Security Act of 1974 for private sector pension plans in the US.

investment fund, and aside from several instances involving the ‘breaking of the buck’ by money market funds (“MMF”), notably the Reserve Primary Fund in September 2008, we are not aware of any substantial instances of an investment fund insolvency. In comparison, the Federal Deposit Insurance Corporation has recorded 546 bank failures in the US since 2000. Even in the case of MMFs, recent regulatory changes, notably new rules from the SEC implementing a floating net asset value requirement for all institutional prime and municipal MMFs, have eliminated the assumption of an implicit price floor for such funds, thereby making it far less likely for an insolvency event to occur in the future. More generally, a historical analysis of regulated investment funds at State Street over a six year look-back period, demonstrates the absence of variation in probability of default estimates across various investment fund categories and investment fund strategies.⁷

Regulated Investment Funds and the Custody Banks

Regulated investment funds, such as ‘40 Act Funds, EU UCITS and other similar national equivalents are an essential feature of the modern financial system, offering retail and institutional investors cost-effective access to pools of investment assets used to accumulate long-term savings. Regulated investment funds are governed by specific legal statute which prescribes, among other, detailed transparency, investor disclosure, asset quality, asset segregation and asset diversification mandates. In addition, they are subject to ongoing regulatory scrutiny designed to ensure the highest level of investor protection. Moreover, there is an additional layer of regulation in place for such funds that stems from the fiduciary responsibility of the investment manager to act in the investor’s best interest and to manage the fund in accordance with its prescribed investment mandate. Regulated investment funds are required to adhere to specific limits on both borrowed funds and leverage. As an example, ‘40 Act Funds are not permitted to incur indebtedness that exceeds 33% of the fund’s total assets. Similarly, retail UCITS are prohibited from borrowing more than 10% of the value of their assets. For other types of UCITS, limits are set by the fund’s investment profile, but generally do not exceed 25% to 40%. Regulated investment funds therefore have limited and well-defined credit needs, which are conservatively supported by custody banks as a normal part of the investment services which they provide.

This includes access to temporary liquidity, for instance, the extension of intra-day credit to smooth out timing differences between the settlement of a securities transaction and the movement of the resulting cash, or the provision of overdraft protection to address a settlement delay or the non-receipt of funds. Custody banks maintain robust systems to ensure the orderly processing of day-to-day transactions within client investment accounts. This includes highly integrated custody and accounting platforms, backed by operational policies and procedures adopted in accordance with national prudential regulation. This also includes systems to control the extent of possible credit exposure to the institutional investor client. While virtually all client transactions settle as expected, there are occasions where a

⁷ The analysis involved a review of quarterly data extending from Q4 2010 through Q1 2016.

transaction may be delayed or fail due to timing, matching, systems or other operational impediments. These typically arise due to unexpected transactional issues, such as a missing or erroneous trade instruction, and are generally only apparent late in the business day when it is beyond the ability of the institutional investor to immediately eliminate or otherwise reduce the exposure. Although these extensions of credit can be sizable when compared to a custody bank's total regulatory capital, they are always short-dated and are backed by the investment fund's underlying assets, or otherwise subject to *de facto* collateralization via a lien or other similar legal agreement.

In addition, custody banks provide short-dated extensions of credit to regulated investment funds on contractual terms, generally referred to as a committed facility, in order to accommodate various liquidity needs that would otherwise require the investment fund to hold large amounts of cash that could undermine investment returns. This includes the processing of client redemptions ahead of the receipt of funds from the sale of underlying investment assets, and the payment of management fees and other expenses. These committed facilities have features that carefully limit both their tenor and usage and therefore the potential risk that they may pose to a custody bank. This includes asset quality and diversification requirements, along with short repayment obligations, typically 30 to 60 days. Furthermore, and as with the provision of overdraft protection, committed facilities to regulated investment funds are backed by the fund's underlying assets, or otherwise subject to *de facto* collateralization via a lien or other similar legal agreement.

As a result, our experience is that committed facilities to regulated investment funds represent limited credit risk and are unlikely to face significant drawn downs, even during periods of financial stress. This was validated by State Street's experience during the financial crisis, where utilization rates for committed facilities extended to '40 Act Funds revealed incremental draw down rates substantially below 10%. We have provided this information to the Basel Committee on several occasions, most recently in a confidential annex accompanying our comment letter on the second consultative document on Revisions to the Standardized Approach for Credit Risk.⁸ To the extent that it would be helpful, we are prepared to do so again in the context of the Basel Committee's work on revisions to the A-IRB approach.

The demand for extensions of credit to regulated investment funds has grown in importance over the past several years as the SEC and other securities market regulators have sought to encourage funds to improve their liquidity risk management practices. As such, committed facilities to regulated investment funds play an important role in ensuring the efficient operation of the financial markets. Indeed, if custody banks such as State Street, were subject to significant restrictions on their ability to offer extensions of credit to regulated investment funds due to poorly-calibrated credit risk-parameters, this would necessitate special operational processes regarding client redemptions and other movements of cash that would

⁸ 'Response to the Second Consultative Document – Revisions to the Standardized Approach for Credit Risk', State Street Corporation (March 11, 2016).

heighten potential transaction risk, increase investor costs and disrupt well-established market efficiencies.

Calibration of the Regulatory Capital Framework for Investment Funds

While we recognize that calibration issues are complex and are best informed by a detailed review of industry data, as a threshold matter, we strongly support the general proposition put forth by the Basel Committee that the ongoing review of the Basel III framework should not result in a significant increase in overall capital requirements. Furthermore, we agree with the views expressed by the Basel Committee in its first consultation on Revisions to the Standardized Approach for Credit Risk that ‘the standardized approach should provide (for) a meaningful differentiation of risk’, that ‘capital requirements should be commensurate with the underlying risk’, and that ‘equal risks should attract the same amount of capital’.⁹

Informed by these key principles and our internal review of client usage and historical loss data, we believe that exposures to regulated investment funds should be assigned a standardized risk-weight of 20%, with exposures to unregulated investment funds assigned a higher risk-weight of 100%. Furthermore, and consistent with the arguments made in our response to the Basel Committee’s second consultation on Revisions to the Standardized Approach for Credit Risk, we recommend the introduction of a CCF for unfunded commitments to regulated investment funds calibrated at 20%, in a manner consistent with the intended approach for trade finance commitments.¹⁰ As previously emphasized, this reflects the essential role which these low risk obligations play in promoting the smooth and efficient operation of the financial markets, and therefore the importance of a CCF that properly accounts for their modest level of inherent risk. As for unregulated investment funds, we believe that these should be assigned a CCF that is consistent with the CCF that the Basel Committee has proposed for unfunded wholesale commitments generally, or somewhere between 50% and 75%.

TREATMENT OF AGENCY-INDEMNIFIED SFT

In Section 4.5 of the consultation on the Credit Risk Mitigation framework, the Basel Committee specifies that ‘banks applying the IRB approaches may still use the value-at-risk (“VaR”) model approach to determine their exposures subject to counterparty credit risk for securities financing transactions’.¹¹ While we welcome this statement, we are unsure how this interacts with the Basel Committee’s parallel decision to remove the IRB approaches for exposures to banks and other financial institutions which are the primary counterparties in the SFT market, including for agency-indemnified SFT. Based upon a conservative interpretation of these

⁹ ‘Consultative Document: Revisions to the Standardized Approach for Credit Risk, Basel Committee on Banking Supervision (December 2014), pages 2, 4 and 5.

¹⁰ Response to the Second Consultative Document – Revisions to the Standardized Approach for Credit Risk’, State Street Corporation (March 11, 2016).

¹¹ Basel Committee Consultation, page 12.

requirements, we believe that what the Basel Committee intends is for A-IRB banks to use VaR methodologies to determine their 'exposure at default' for SFTs, with the resulting exposure amount then subject to standardized risk weights based upon the underlying counterparty type. Nevertheless, in order to avoid any potential misunderstanding of the requirement, we would welcome timely confirmation that this approach is correct.

CONCLUSION

Thank you once again for the opportunity to comment on the important matters raised within this consultation. To summarize, while we recognize growing supervisory interest in the use of standardized methodologies for the assessment of credit risk, and we do not oppose changes to the A-IRB framework intended to improve the comparability of risk-based outcomes, address excessive variability in RWA and reduce unwarranted complexity, we do not believe that it is appropriate to rely on the standardized methodology for corporate exposures to measure the credit risk profile of investment funds.

We therefore recommend that the Basel Committee defer a decision regarding the removal of the A-IRB approaches for the measurement of exposures to investment funds and that it establish a dedicated work-stream to develop an alternative standardized framework for such funds, distinct from the general category of corporate exposures. Once completed, we believe that the Basel Committee should use this revised standardized framework as the basis for determining whether to proceed with the abandonment of the A-IRB approach for investment fund exposures in favor of a standardized alternative.

Given the central importance of investment funds to the custody bank business model, we believe that it is essential for the Basel Committee's work to be informed by the experience of the stand-alone custody banks, and we stand ready to provide whatever assistance may be required in this effort. This includes quantitative information on our primary risk exposures, client types, historical usage, and loss experience. Furthermore, we welcome the opportunity to clarify any particular matter of interest.

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