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Secretariat of the Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel
Switzerland

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Consultative Document – Global Systemically Important Banks – Revised Assessment Framework

Dear Sir/ Madam:

State Street Corporation ("State Street") welcomes the opportunity to comment on the Basel Committee on Banking Supervision's ("Basel Committee") proposal to revise certain aspects of the assessment methodology for global systemically important banks ("G-SIB"), which is used by regulatory authorities to determine required amounts of additional risk-based capital to offset each firm's perceived contribution to systemic risk, or what is commonly referred to as the 'G-SIB surcharge'. Finalized in July 2013, the existing G-SIB assessment methodology includes a cap on the 'substitutability' category, one of the five metrics used to quantify the presence of systemic risk within the banking system, based on the Basel Committee's conclusion that the 'substitutability' category has a "greater impact on the assessment of systemic importance than intended for banks which are dominant in the provision of certain types of financial services".[1] This includes safekeeping and asset administration services, as reflected in the indicator for 'assets under custody'.

Among the changes now proposed by the Basel Committee is the removal of the cap on the 'substitutability' category, based on the further assertion that the cap "reduces banks'

[1] 'Global Systemically Important Banks – Updated Assessment Methodology and the Higher Loss-Absorbency Requirement', Basel Committee on Banking Supervision (July 2013), Paragraph 19.

incentives to become less systemically important".[2] We strongly oppose this proposed change which would result in a substantial overstatement of the risk inherent in the provision of custody services, and therefore the highly disproportionate treatment of the custody bank business model. If the Basel Committee nonetheless decides to move forward as intended, we recommend that it combine the removal of the cap on the 'substitutability' category with the recalibration of the risk-weight for 'assets under custody'.

In addition, while we oppose the Basel Committee's proposal to incorporate a new indicator in the assessment methodology for short-term wholesale funding ("STWF"), we offer our perspective on certain features of such an indicator, based on our experience as one of eight United States ("US") banks subject to the Board of Governors of the Federal Reserve System's ("FRB") Method 2 G-SIB approach, which incorporates its own measure of STWF.[3] This includes the importance of recognizing the way in which various sources of STWF are managed on the asset side of the balance sheet.

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 $29.8 trillion in assets under custody and administration and $2.6 trillion in assets under management, State Street operates in 30 countries and in more than 100 geographic markets.[4] State Street is organized as a US bank holding company ("BHC"), and is one of only two stand-alone custody banks which have been designated as a G-SIB. As a stand-alone custody bank, we derive a substantial amount of our revenue from fee-based income, rather than from the generation of yield on credit risk assets. For instance, as of March 30, 2017, fee-based revenue comprised 82.4% of our total revenue. Similarly, we make relatively few loans and we do not engage in significant trading or other capital markets activities. As of March 30, 2017, our Basel III advanced approach common equity Tier 1 ("CET1") ratio was 11.2% and our Basel III standardized approach CET1 ratio was 11.5%. Our estimated *pro forma* supplementary leverage ratio equaled 6.1% at the level of the BHC and 6.6% at the level of our primary bank subsidiary.

Our perspective in respect of the Basel Committee's proposal 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 foreign equivalents; corporate and public retirement plans; sovereign wealth funds; central banks; alternative investment funds; insurance company accounts; charitable foundations and endowments. We appreciate the opportunity to offer insight relative to the impact of the Basel Committee's proposal on our role as a custodial entity, a role that is widely

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[2] Basel Committee on Banking Supervision Consultative Document, page 5.
[3] 'Regulatory Capital Rules: Implementation of Risk-Based Capital Surcharges for Global Systemically Important Bank Holding Companies', Board of Governors of the Federal Reserve System, Federal Register Volume 80, Number 157 (August 14, 2015), page 49082.
[4] As of March 30, 2017.

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.

We have participated in the development of the responses prepared by various financial services trade groups, notably the submission from The Clearing House Association and the submission from the Institute of International Finance of which we are members, 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.

ELIMINATION OF THE CAP ON THE SUBSTITUTABILITY CATEGORY

State Street acknowledges the Basel Committee's efforts to create an assessment methodology for G-SIBs which serves as a reasonable proxy for the presence and distribution of systemic risk within the banking system. We also acknowledge the Basel Committee's decision to regularly review and update that methodology to "ensure that the framework remains consistent with its objectives".[5] This includes its commitment, when it first introduced the G-SIB assessment methodology, to review the implementation of the cap on the 'substitutability' category. However, by choosing to remove the cap without also addressing the underlying mis-calibration of the indicator for 'assets under custody', the Basel Committee's approach will result in an assessment methodology that unfairly penalizes the custody bank business model.

There are several considerations which lead us to oppose the Basel Committee's proposal in its current form. First, unlike any of the other indicators in the G-SIB assessment methodology, 'assets under custody' is an off-balance sheet construct which reflects the total value of assets held by a custodian bank on behalf of its clients. While the volume of 'assets under custody' can appear quite significant, these assets do not belong to the custodian bank, do not create any exposure for the bank, and cannot be used by the bank to meet its financial obligations. Furthermore, 'assets under custody' are segregated from the custodian bank's proprietary assets and cannot be used to offset the bank's liabilities in the event on insolvency. As such, it is extremely difficult to compare reported amounts of 'assets under custody' to any of the other indicators in the G-SIB assessment methodology, and to extrapolate from this metric a reasonable and proportionate measure of systemic risk. [6]

Second, the rationale used by the Basel Committee to support the elimination of the cap on the 'substitutability' category - that the cap "reduces the impact of a (given) category in the overall

[5] Basel Committee on Banking Supervision Consultative Document, page 2.

[6] It's also worth considering that the 'assets under custody' metric does not account for the pronounced 'double counting' of assets which results from the structure of the global custody industry, where the same asset may be reflected at multiple levels in the chain of financial intermediation. For instance, assets which a global custodian bank holds on behalf of its clients with a local sub-custodian bank will be reported as an 'asset under custody' by both custodian banks, thereby resulting in a material overestimation of total global 'assets under custody'.

G-SIB score" - is unpersuasive and directly contradicts the initial rationale for the cap, which is to address the over-estimation of the systemic risk posed by banks which are active in the provision of certain financial services, notably safekeeping and asset administration services as reflected in 'assets under custody'.[7] We emphasize, in this respect that the Basel Committee's commitment to review the cap on the 'substitutability' category in 2013 was predicated on "revisions to the (G-SIB) methodology that may allow (the cap) to be removed".[8] This could include, for instance, a recalibration of the risk-weight for 'assets under custody' in order to diminish the impact of this indicator on a bank's 'substitutability' score. Unfortunately, since no such revision has been proposed, what the Basel Committee is effectively contemplating is removing the cap on the 'substitutability' category without addressing the underlying reason why such as cap was necessary in the first place.

Third, the Basel Committee's proposal has a highly idiosyncratic impact on a small number of banks which are active in the provision of custody services in a manner that opens the Basel Committee to criticism that its approach is selectively punitive. Indeed, the Basel Committee acknowledges in the consultative document that the proposed change would have an impact on only four G-SIBs, all of which are US BHCs that lead the financial industry in the provision of seamless, cost-effective and value-added safekeeping and asset administration services which help promote the safety of client assets and the stability of the financial system. Furthermore, the summary statistics in Table 4 of the consultative document demonstrate that the maximum impact of the removal of the cap on the 'substitutability' category on the universe of G-SIBs is 118 basis points, which is more than twice the impact of any of the other proposed methodological changes.[9]

In our view, these considerations clearly reflect the inherent mis-calibration of 'assets under custody' in the G-SIB assessment methodology, and therefore the need for the Basel Committee to undertake a more comprehensive review of the impact of its proposed approach on the custody bank business model. As such, we strongly oppose the proposal to remove the cap on the 'substitutability' category without a corresponding recalibration of the risk-weight for 'assets under custody." More specifically, we recommend that the weighting for 'assets under custody' be adjusted so that its relative weighting is no greater than that of any other indicator used to assess the presence of 'substitutability' related risk. Based on the proposed introduction of a new indicator for 'trading volume', this would imply a reduction in the existing 6.67% risk-weight to 3.33%, or alternatively, if an equal weight is assigned to all indicators within the 'substitutability' category, to 5.00%

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[7] 'Global Systemically Important Banks – Updated Assessment Methodology and the Higher Loss-Absorbency Requirement', Basel Committee on Banking Supervision (July 2013), Paragraph 19.

[8] 'Global Systemically Important Banks – Updated Assessment Methodology and the Higher Loss-Absorbency Requirement', Basel Committee on Banking Supervision (July 2013), Page 6, Footnote 10.

[9] The Basel Committee notes in Table 4 of the consultation that expanding the scope of consolidation to include bank-owned insurance subsidiaries would have a maximum impact of 57 basis points.

INTRODUCTION OF A NEW INDICATOR FOR SHORT-TERM WHOLESALE FUNDING

State Street recognizes the importance of measures taken by the regulatory community to limit excessive industry reliance on unstable sources of wholesale funding. This includes implementation of the Basel III liquidity framework, notably the Liquidity Coverage Ratio, which is designed to address potential instances of financial market stress over a thirty-day horizon. Nevertheless, we do not believe that it is appropriate for the Basel Committee to implement an indicator for STWF in the G-SIB assessment methodology. This reflects our strongly held view that liquidity-related concerns, even those which may be systemic, should not be addressed via the regulatory capital framework. Still, to the extent that the Basel Committee decides to proceed with the implementation of such an indicator, we agree that it would make sense for it to be included within the 'interconnectedness' category. We also agree with the Basel Committee's contention that it is essential to carefully examine the various sources of funding that may be included in an indicator for STWF, "keeping in mind that some sources (of STWF) are more stable than others".[10]

From our experience as a US G-SIB, one of the most pressing flaws in the FRB's methodology for the measurement of a bank's reliance on STWF (*i.e.* the Method 2 approach), is that it fails to distinguish between various categories of wholesale funding, uniformly assuming that these liabilities have no value as a source of stable funding. In the specific case of the custody banks, this is reflected in the FRB's decision to treat excess amounts of custody deposits as STWF, even though these deposits are linked to the provision of safekeeping and asset administration services, and are not used as a means of funding the custody bank balance sheet. Instead, excess amounts of custody deposits are managed by custodian banks in the most conservative way possible, through placements with national central banks, or through investments in certain highly liquid assets, such as high-quality, short-dated sovereign debt.

Conceptually speaking, the mischaracterization of excess amounts of custody deposits as STWF in the FRB's Method 2 approach reflects the lack of recognition for the way in which deposit liabilities are managed on the asset side of the balance sheet. As such, the Method 2 approach overlooks the reality that the effective management of liquidity risk depends upon the implementation of a coherent asset-liability management strategy. We therefore recommend that the Basel Committee take a considered view of the stability profile of various sources of wholesale funding in any potential STWF indicator, taking into account the scope of the maturity mismatch between the bank's liabilities and the bank's assets. This includes the potential implementation of an offset for various sources of STWF managed via placements with national central banks or investments in short-dated, high-quality sovereign debt.

Indeed, in our view, it would be highly unreasonable if a measure intended to gauge the scope of a bank's reliance on STWF were to lead to an increase in the G-SIB surcharge due solely to wholesale deposit inflows offset by essentially riskless assets. Furthermore, should the Basel

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[10] Basel Committee on Banking Supervision Consultative Document, page 15.

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Committee proceed with the introduction of an indicator for STWF, we recommend that it should confirm its expectation that such an indicator is intended to create a globally consistent approach, and therefore replace any existing national version of the same metric.

CONCLUSION

Thank you once again for the opportunity to comment on the important matters raised within this consultative document. To summarize, State Street strongly opposes the Basel Committee's proposal to remove the cap on the 'substitutability' category in the G-SIB assessment methodology since this would result in the disproportionate treatment of the custody bank business model. In our view, this reflects the inherent incompatibility of an off-balance sheet construct, such as 'assets under custody', in a methodology that is otherwise designed to assess the scope of on-balance sheet risk.

Recognizing the impact which this had on the distribution of risk assessment scores, the Basel Committee made the reasoned decision to incorporate a cap on the 'substitutability' category in its original G-SIB assessment methodology, while committing to its review in conjunction with methodological changes that would allow for its removal. As such, we recommend that if the Basel Committee chooses to move forward with the elimination of the cap on the 'substitutability' category, it should do so in conjunction with the re-calibration of the risk-weight for 'assets under custody,' using as a reference, that 'assets under custody' should not be weighted any more heavily than any other indicator within the 'substitutability' category.

Furthermore, while we do not support the introduction of an indicator for STWF in the G-SIB assessment methodology, to the extent that the Basel Committee decides to move forward with this effort, we believe that it must carefully consider the funding profile of various sources of STWF in order to account for differences in their underlying characteristics. In particular, we suggest the use of a mechanism to account for the way in which various sources of wholesale funding are managed on the asset side of the balance sheet; specifically the introduction of an offset for excess amounts of custody deposits managed via placements with national central banks or investments in short-dated, high-quality sovereign debt.

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

Sincerely,

Stefan M. Gavell