



State Street Corporation

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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 – Interest Rate Risk in the Banking Book

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 interest rate risk in the banking book (“IRRBB”). The Consultation outlines two options for changes to the existing regulatory treatment of IRRBB. The first involves the introduction of a standardized Pillar 1 minimum capital requirement (“standardized Pillar 1 framework”), with four potential calculation methodologies. The second involves an enhanced Pillar 2 approach centered on the use of a standardized measure of IRRBB (“standardized IRRBB calculation”) as a means of achieving greater “consistency, transparency and accuracy” in the assessment of risk.¹

While we recognize the importance of an effective framework for the “identification, measurement, management and control” of interest rate risk by internationally active banks, we are strongly opposed to the use of standardized metrics in the evaluation of IRRBB.² This includes both the introduction of a standardized Pillar 1 framework and the use of a standardized IRRBB calculation in the enhanced Pillar 2 approach. This reflects the reality that a “one-size fits all” approach to IRRBB cannot capture with any degree of accuracy a firm’s individual interest rate risk profile, and therefore the strong potential for highly misleading regulatory outcomes. This is especially true in the case of non-traditional banks, such as stand-

¹ Basel Committee Consultative Document, page 1.

² Basel Committee Consultative Document, page 4.

alone custody banks, whose unique business models are not well-adapted to a standardized view of interest rate risk.

Headquartered in Boston, Massachusetts, State Street specializes in providing institutional investors with investment servicing, investment management and investment research and trading. With \$28.7 trillion in assets under custody and administration and \$2.4 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, with operations conducted through several entities, primarily its wholly-owned bank subsidiary, State Street Bank and Trust Company. We have among the highest capital levels in the industry, with a Basel III advanced approach common equity Tier 1 (“CET1”) ratio of 12.2% and a Basel III standardized approach CET1 ratio of 11.6%.³

Our perspective in respect of the Basel Committee’s 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 accounts; charitable foundations and endowments. We appreciate the opportunity to offer insight relative to the impact of the Consultation on our role as 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.

INTRODUCTORY COMMENTS

State Street recognizes the growing emphasis among supervisory authorities on improving the design of risk-based measures of capital and we acknowledge that there are differing views regarding the best way to address IRRBB. Moreover, we welcome the open and constructive manner in which the Basel Committee has approached the development of potential policy alternatives for IRRBB, including extensive industry outreach throughout the course of 2014. Nevertheless, we have serious reservations regarding the IRRBB framework proposed by the Basel Committee. This reflects its broad reliance on standardized methodologies which we view as inherently maladapted to the custody bank business model.

The Basel Committee has historically relied on a Pillar 2 approach for the regulatory treatment of IRRBB, based upon the view that the “management and measurement of interest rate risk are not amenable to an internationally harmonized Pillar 1 framework”.⁴ In view of the substantial diversity in the structure of banking books across national jurisdictions, product offerings and business models, along with the presence of varying regulatory practices and

³ As of June 30, 2015.

⁴ Basel Committee Consultative Document, page 9.

standards, we strongly believe that Pillar 2 remains the appropriate basis for the regulatory treatment of IRRBB. Furthermore, while we recognize the concerns raised by the Basel Committee regarding the lack of comparability in the current Pillar 2 framework, we believe that the proposed use of a standardized IRRBB calculation as a benchmark for banks globally is unworkable and would result in the highly misleading assessment of risk. We therefore suggest the development of a revised Pillar 2 approach designed to strengthen industry and supervisory practices, along with improved transparency to the market, while respecting differences in industry business models and prevailing national standards.

We have participated in the development of the detailed responses submitted by various financial services trade groups, notably comments from the American Bankers Association and joint comments from The Clearing House Association, the Securities Industry and Financial Markets Association and the Financial Services Roundtable, 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.

THE UNIQUE FEATURES OF THE CUSTODY BANK BUSINESS MODEL

Custody banks are uniquely focused on serving the investment needs of institutional investor clients. These clients contract with custody banks, such as State Street, 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. This also includes various asset servicing functions, such as the processing of income and other interest payments, corporate action events, tax reclamations, operating fees and expenses, and client subscriptions and redemptions. Furthermore, custody banks provide a number of value-added services, such as fund accounting and valuation, fund administration, middle office outsourcing, and performance measurement and analytics, which derive from the safekeeping and administration of assets. This results in large amounts of fee-based revenue and correspondingly smaller amounts of net interest income (“NII”). Indeed, in the case of State Street, NII has historically represented approximately 25% of our total revenue, compared with the typical industry range of between 50% to 60%.

Institutional investors have significant day-to-day operational needs which require access to deposit accounts and cash management services typically performed by custody banks. At its most basic level, custody banks therefore provide the equivalent of checking accounts for investment funds, with deposit inflows and outflows tied to normal course transactional activities in portfolios of investment assets. This results in a highly stable deposit base with funding characteristics which are distinct from other types of wholesale deposits. Indeed, the strong operational dependencies of the custody bank business model is one of the primary factors that led the Basel Committee to incorporate within the Basel III liquidity framework, a specific category for operational deposits as distinct from wholesale funding generally. This centers on a more favorable draw-down rate in the Liquidity Coverage Ratio (“LCR”) and the

Net Stable Funding Ratio (“NSFR”) for deposits resulting from “clearing, custody and cash management activities”, due to the need for clients “to leave (such) deposits with a bank in order to facilitate their access to and ability to use payment and settlement systems, and otherwise make payments”.⁵

While institutional investors aim to make appropriate use of available cash, there are occasions where clients maintain excess amounts on deposit with their custodian bank. This is especially true in periods of financial market uncertainty as institutional investors seek to adjust their risk exposures or otherwise rebalance their investment allocations. This “flight to cash” phenomenon can at times be quite significant and therefore lead to substantial spikes in balance sheet assets. More recently, custody banks have experienced over the course of the past several years a more sustained increase in inflows of excess client cash. This can be seen in a greater than 40% increase in client deposit balances since 2011 and appears to reflect a combination of unprecedented central bank stimulus, generalized macro-economic uncertainty and regulatory requirements limiting institutional investor access to alternative investment options, such as repurchase agreements, money market funds and short-term commercial paper.⁶

The ability to differentiate between stable core deposits and excess deposit balances has therefore become a central feature of global prudential regulation and custody banks make use of highly conservative strategies to manage temporary inflows of client cash. This involves the placement of excess amounts with national central banks. This is designed to permit custody banks to support their client’s need for a safe store of value which can be quickly retrieved without loss of principal, while minimizing risk to the custody bank, the client and the financial system as a whole. The importance of this low-risk strategy in the management of our liabilities can be seen in levels of central bank placements relative to total assets over the past six quarters of well in excess of 25%. As a result, custody banks, such as State Street have much lower levels of risk-weighted assets (“RWA”) than most of their industry peers. Consequently, they are able to manage their balance sheets with smaller amounts of total capital.

Custody banks have balance sheets which are constructed differently than other banks with extensive retail, commercial and investment banking operations. The custody bank balance sheet is liability driven, with highly stable core deposit balances used to fund the purchase of large and well-diversified portfolios of high-quality investment assets. Unlike other large internationally active banks for whom the Basel Committee standards are intended, custody banks make relatively few loans and do not engage in the asset securitization process. In addition, they do not undertake significant trading or capital markets activities and are not reliant on large amounts of term funding to manage their business functions. This results in lower levels of credit risk, along with net interest margins (“NIM”) which are well-below

⁵ ‘Basel III: The Liquidity Coverage Ratio and Liquidity Risk Monitoring Tools’, Basel Committee on Banking Supervision (January 2013), paragraph 93.

⁶ Total State Street client deposits as of Q4 2011 totaled \$152.4 billion, rising to \$170.4 billion as of Q4 2013 and \$219.3 billion as of Q2 2015.

industry averages. We estimate, in this respect, NIM for custody banks of approximately 1.0%, compared to a more typical industry NIM among large commercial banks of approximately 2.6% and among mid-sized regional banks of approximately 3.5%.⁷ Furthermore, custody banks have very modestly sized trading books, which greatly limits the potential for the kind of regulatory arbitrage that the Basel Committee cites as one of the primary drivers for its proposed changes to the regulatory treatment of IRRBB.

In effect then, the specialized nature of the custody bank business model results in an interest rate risk profile that is unique and therefore not well-adapted to the standardized methodologies envisioned by the Basel Committee. The practical challenges inherent in the application of a standardized IRRBB framework to the custody bank business model can be demonstrated by considering several examples of the variability of regulatory outcomes driven solely by the underlying business model of two hypothetical banks.

The first example, which is further explained in Exhibit 1, demonstrates that two equally-sized banks (one hypothetical custody bank and one hypothetical commercial bank) with the same economic value of equity (“EVE”) interest rate risk and the same capital ratio can have different EVE ratios when subject to a 200 basis point shock depending upon the relative credit risk profile of the bank.⁸ In this example, the hypothetical custody bank with total RWA of \$200 billion and a large portfolio of high-quality investment assets faces a decline in EVE equal to 10.0% of total capital vs. the hypothetical commercial bank with total RWA of \$300 billion and a correspondingly sized lending portfolio, where the decline in EVE is limited to 6.7%. The second example, which is further explained in Exhibit 2, demonstrates that the same two hypothetical banks with the same level of total assets and the same NII interest rate risk profile can have a different percentage change in NII when subject to a 100 basis point shock solely as a result of differences in underlying credit risk. In this example, the hypothetical custody bank with an average NIM of 1.0% suffers a decline in NII under shock of 10.0% vs. the hypothetical commercial bank with an average NIM of 3.0%, which suffers a much smaller decline of 3.3%.

In effect then, custody banks face the very real prospect of being incorrectly perceived, using the standardized methodologies envisioned by the Basel Committee, as “outlier banks” with inadequate capital for interest rate risk, even though custody banks have among the lowest levels of RWA and the highest levels of capital in the industry. Indeed, we are deeply concerned that the intended use of a “one-size fits all” approach for IRRBB with substantial levels of embedded conservatism, will result in the highly misleading assessment of our risk profile, with the potential for lasting damage to our reputation as a highly capitalized bank with stable and consistent earnings, among analysts, investors and our clients.

⁷ Based on Q2 2015 data. Reference custody banks are State Street Corporation, Bank of New York Mellon and Northern Trust. Reference commercial banks are JP Morgan Chase, Bank of America, Citigroup and Wells Fargo. Reference regional banks are US Bancorp, PNC, Capital One, BB&T, Fifth Third Bancorp, Sun Trust Bank and Regions Financial.

⁸ EVE Ratio equals the change in EVE for an interest rate shock scenario relative to total capital.

WEAKNESSES IN THE STANDARDIZED MEASURE OF IRRBB

There are several features of the Basel Committee's proposed framework for the regulatory treatment of IRRBB which we view as particularly punitive for custody banks and therefore where further explanation may prove helpful in supporting our position that the assessment of IRRBB is not amenable to standardized methodologies and should therefore continue to be undertaken on a Pillar 2 basis with appropriate levels of national discretion.

First, the Basel Committee identifies two banking book positions which it views as not conducive to standardization and therefore where separate treatment for interest rate risk is warranted. The first of these are non-maturity deposits ("NMD") defined as deposit liabilities of a bank which can be withdrawn at any time since there is no defined maturity date. The second are certain types of assets with behavioral options, such as asset-backed securities ("ABS") with prepayment risk that may change underlying cash flows and which therefore make it difficult to categorize within standardized maturity buckets. As noted in the previous section of our comment letter, the custody bank balance sheet is comprised almost entirely of NMDs, the stable portion of which are monetized through the purchase of portfolios of investment assets, including substantial amounts of ABS. In a very real sense therefore, the custody bank business model is the purest example of a business model that is not amenable to standardization and therefore where the likelihood of a substantial mis-statement of interest rate risk is greatest.

Second, while the Basel Committee differentiates "retail transactional" deposits from "retail non-transactional" deposits when setting stability caps and pass through floors for NMDs, it does not do so for wholesale deposits. This approach is surprising since it appears to disregard the crucial distinction drawn by the Basel Committee in the Basel III liquidity framework between operational deposits and wholesale deposits generally. As explained in the previous section of our comment letter, this distinction is designed to recognize the particular stability of deposit balances tied to "clearing, custody and cash management activities" which are central to the custody business model and which are assigned a preferential outflow rate of 25% for purposes of the LCR and 50% for purposes of the NSFR. This compares with a 100% outflow rate for wholesale deposits generally.

As such, the Basel Committee envisions the use of a stability cap and a pass through floor for our core deposit base (i.e. "wholesale transactional deposits") which are highly punitive and which are unrelated to any empirical assessment of interest rate risk. This is especially true in a more normalized interest rate environment as elevated levels of client deposit balances resulting from a combination of monetary, macro-economic and market factors, begin to leave the custody bank balance sheet. Indeed, there is substantial evidence that core custody deposits are stable over a multi-year horizon and therefore warrant similar IRRBB assumptions than those envisioned for "retail transactional" deposits, or an implied stability cap of 60%.

Similarly, the Basel Committee proposes to require the use of a three-year weighted average life ("WAL") and a maximum maturity of six years for all NMDs which are identified as core deposits. While we acknowledge the Basel Committee's desire to forgo some level of

granularity in favor of simplicity in the assessment of duration risk, these assumptions are unnecessarily conservative, especially when applied to our custody deposit base. Since NMDs represent the primary source of funding for custody banks, we have devoted considerable effort to understanding the complex inter-dependencies of customer pricing, product usage and the nature of the overall customer relationship with our custody clients. Based upon this analysis, we believe that the duration requirements specified by the Basel Committee substantially underestimate WAL for our core deposit base, an outcome that would force custody banks to shorten the duration of their investment portfolios in a manner unsupported by actual customer behavior. This would, in turn, increase the risk profile of our balance sheet by compelling us to manage the duration of our assets in a manner that does not correspond with the actual duration risk of our deposit funded liabilities.

Third, the interest rate shock scenarios prescribed by the Basel Committee do not envision negative rates which are common in today's market environment, notably for wholesale transactions in various European currencies such as the Euro, Danish Krona and Swiss Franc. In view of the global presence of custody banks driven by the need to support client investment activities across the world's financial markets, along with our broad reliance on assets and liabilities tied to the short-end of the yield curve, this limitation could result in the mischaracterization of our interest rate risk. Similarly, since custody banks do not engage in foreign currency transactions in order to take interest rate risk and since their exposures tend to be concentrated in major G-7 currencies whose interest rates are closely correlated with US rates, the imposition of a uniform 75% haircut for net positive currencies under stress is highly punitive and would result in an inaccurate view of our balance sheet risk.

Fourth, there are various features of the proposed standardized calculation methodologies for IRRBB which are not particularly well-suited to the custody bank business model and which may therefore result in an overestimation of our interest rate risk. As an example, the use of a standardized EVE metric along with the calculation of NII based on gone concern cash flows is punitive for custody banks given our much smaller amounts of total capital. This is demonstrated in the quantitative example provided in Exhibit 1 of our comment letter, and indeed custody banks could reduce their EVE related outcomes by increasing the amount of their overall credit risk, an approach that is both counter-intuitive and contrary to the logical intent of a risk-based measure of capital.

Furthermore, we note the impact for custody banks of standardized calculation methodologies that do not permit the full offset of NII relative to EVE, and which define earnings-based measures in a manner that does not account for non-interest income. This reflects our role as a provider of financial services to institutional investors, which results in large amounts of highly stable fee-based revenue and a correspondingly smaller amount of NII. Therefore, we believe that a more appropriate methodology for the measurement of IRRBB under shock would center on the use of a bank's total revenue as opposed to NII, coupled with the ability to fully offset the resulting earnings-based outcome against the corresponding EVE measure. As for possible concerns that banks subject to the Basel Committee framework may seek to use a full offset for NII or total revenue as a means of gaming EVE, we believe that this can effectively be addressed

via the supervisory process rather than via the imposition of standardized parameters that do not properly recognize the intrinsic benefits of earnings-based outcomes.

Finally, in Principle 12 of its enhanced Pillar 2 approach, the Basel Committee proposes the adoption of a standardized “outlier test” based upon the ratio of a bank’s EVE to either Tier 1 capital or CET1 capital under shock, with banks falling above that ratio presumed to have an undue level of interest rate risk. Given the specialized nature of the custody bank balance sheet, which as previously noted is not amenable to a standardized view of IRRBB, we believe that the intended “outlier test” is likely to produce outsized results for custody banks notwithstanding their much lower levels of embedded risk. This includes RWAs which are well below the industry average, lower amounts of credit and market risk, and capital levels which are among the highest in the industry. In effect then, IRRBB cannot be accurately measured in isolation using standardized parameters, and should instead be considered as part of a bank’s overall balance sheet risk, a firm specific standard which is best implemented using a Pillar 2 framework with appropriate levels of national discretion. We note, in this respect, that this approach is consistent with the US FRB’s Comprehensive Capital Analysis and Review process, which has been used as a means of assessing risk-based capital under stress for the largest US banks since 2011 and which is widely viewed as an effective tool for managing overall balance sheet risk.

CREDIT SPREAD RISK IN THE BANKING BOOK

Notwithstanding the Basel Committee’s focus on the regulatory treatment of IRRBB, Principle 1 of the enhanced Pillar 2 approach specifies that internationally active banks must also identify, measure, monitor and control credit spread risk in the banking book (“CSRBB”). This is followed by the general observation that CSRBB refers to “any kind of asset spread risk of credit risky instruments that is not explained by general IRRBB or by the expected credit/jump to default risk”.⁹ While this appears to be broadly consistent with existing supervisory expectations and industry practice, at least in the US, the reference to CSRBB is sufficiently broad that it is extremely difficult to judge the Basel Committee’s intent.

As such, we believe that it may be useful for the Basel Committee to clarify its expectations, thereby enabling the industry to better understand the specific matters that may be of interest to it relative to the assessment of CSRBB and therefore to engage in a more constructive exchange of views. In the interim and, in order to mitigate possible interpretations which could unfairly disadvantage our custody bank business model, we strongly suggest that CSRBB should not be considered within a narrow sub-category of assets, but across the balance sheet as a whole. This reflects the reality that credit spread risk can be present in loans and other similar interest bearing assets in the event of liquidation, and should therefore not be pre-emptively

⁹ Basel Committee Consultation, page 39.

limited to certain investment assets (i.e. available-for-sale securities) solely on the basis of prevailing accounting standards.

STRENGTHENING THE CURRENT PILLAR 2 FRAMEWORK

As previously noted, in view of the substantial limitations inherent in the standardized assessment of IRRBB, we strongly oppose the enhanced Pillar 2 approach envisioned by the Basel Committee. This reflects the presence of a standardized IRRBB calculation that is not well-adapted to the custody bank business model and which is therefore likely to result in the substantial mischaracterization of our interest rate risk profile. This includes potential designation as an “outlier bank”, along with the imposition of unwarranted capital restrictions and/or supervisory expectations. Nevertheless, we do recognize the concerns expressed by the Basel Committee regarding the lack of comparability in the current Pillar 2 framework for IRRBB.

In response, we therefore recommend that the Basel Committee implement a revised Pillar 2 approach in which internationally active banks would be required to report, in a consistent format, the aggregate results of the six interest rate shock scenarios for EVE and the two interest rate shock scenario for NII specified in the Consultation, using the internal measurement systems which banks have developed to assess their respective levels of interest rate risk. These results would, in turn, be used as part of the existing supervisory process to ensure the presence of a sufficiently rigorous IRRBB risk management framework, backed by “effective corporate governance, policies and procedures, risk measuring and monitoring systems, stress testing and internal controls related to (a bank’s) interest rate risk exposure”.¹⁰ This approach should not, however, include any specific capital presumption or outcome, which should instead be left entirely to national discretion.

CONCLUSION

Thank you once again for the opportunity to comment on the important matters raised within this Consultation. To summarize, while we recognize the importance of an effective framework for the assessment of interest rate risk, we are strongly opposed to the use of standardized metrics in the “identification, measurement, management and control” of IRRBB.¹¹ This extends not only to the proposed introduction of a standardized Pillar 1 framework, but also to the requirement in the enhanced Pillar 2 approach to calculate and disclose a standardized measure of IRRBB as a means of assessing relative levels of interest rate risk. This reflects the substantial diversity in product offerings, business models, organizational constructs and national regulatory standards which apply across the banking industry, and therefore the

¹⁰ Joint US Interagency Advisory on Interest Rate Risk Management (Jan. 6, 2010), page 1.

¹¹ Basel Committee Consultative Document, page 4.

inadequacy of a “one-size fits all” approach as the basis for an internationally harmonized standard. This is especially true in the case of non-traditional banks, such as stand-alone custody banks, whose unique business models are not well-adapted to the standardized assessment of interest rate risk.

We therefore suggest the development of a revised Pillar 2 approach designed to strengthen industry and supervisory practices, and improve transparency for various stakeholders, while respecting differences in industry business models and prevailing national standards. This involves the required reporting, in a consistent format prescribed by the Basel Committee, the aggregate results of the six interest rate shock scenarios for EVE and the two interest rate shock scenario for NII specified in the Consultation, using internally developed methodologies. These calculations would, in turn, be used as a means of enhancing the existing supervisory process for IRRBB based upon the presence of a robust risk management and control framework, but without any specific capital presumption or outcome which would continue to be a matter of national discretion.

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

Exhibit 1

Two institutions, with the same EVE interest rate risk and capital profile, have different EVE ratios depending on the relative credit risk taking

	Hypothetical Custody Bank LOW Credit Risk	=	Hypothetical Commercial Bank HIGH Credit Risk
Δ EVE under +200 bps shock	-\$2.0 BN		-\$2.0 BN
RWA	\$200 BN		\$300 BN
	Assets heavily weighted to Investment Portfolio (Asset Backed Securities)		Assets heavily weighted to Loans (Credit Card, Auto, Commercial)
Total Capital (Tier 1 + 2)	\$20 BN	=	\$30 BN
Total Capital Ratio	10%		10%
Δ EVE NII as % of total capital under +200 bps shock	-10.0%		-6.7%

Even though \$ EVE sensitivity to rate movements and capital ratios are the same, EVE sensitivity ratios are very different solely due to different credit risk taking (different RWA and capital \$ for similar capital ratio)

Exhibit II

Two institutions with the same interest rate risk profile have different NII risk ratios depending on the relative credit risk taking

	Hypothetical Custody Bank LOW Credit Risk	=	Hypothetical Commercial Bank HIGH Credit Risk
Δ NII under -100 bps shock	-\$1.0 BN	=	-\$1.0 BN
Average earning assets (12M trailing)	\$1,000 BN		\$1,000 BN
1Y net interest income	\$10 BN		\$30 BN ¹
NIM (12M trailing)	1.00%		3.00%¹
Δ NII as % 12M trailing NII	-10.0%		-3.3%

Even though \$ NII sensitivity to rate movements is the same, NII sensitivity ratios are very different solely due to different credit risk taking (different NIM and NII)

¹ Higher interest income and NIM due to increased credit risk taking and associated spread