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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: Revisions to the Basel III Leverage Ratio Framework

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 Basel III leverage ratio framework. Initially published in January 2014, the Basel III leverage ratio framework introduces a minimum leverage ratio requirement of 3% of Tier 1 capital for large internationally active banks, designed to serve as a credible supplement to the Basel Committee's risk-based capital framework. It is intended to be effective beginning January 2018, with public disclosure of a banking entity's *pro forma* ratio required as of January 2015. Based on the results of the Basel III monitoring exercise, feedback received from various market participants and discussions held among senior supervisory and central bank officials, the Basel Committee is seeking comment on a number of adjustments to the design of the existing Basel III leverage ratio framework. These adjustments include changes to certain components of the framework, such as the methodology for the measurement of exposures to over-the-counter ("OTC") derivatives transactions, and a request for views on a potential leverage ratio surcharge for those large internationally active banks which have been designated by the Financial Stability Board ("FSB") as global systemically important banks ("G-SIB").

While we welcome the Basel Committee's decision to review the design of the Basel III leverage ratio framework, we believe that the scope of its effort is too narrow and that the Basel Committee should actively consider changes to other aspects of the framework that do not appropriately reflect the particular characteristics and risk profile of certain additional assets.

In particular, we wish to draw the Basel Committee's attention to the treatment of central bank placements, all but risk-free assets which are routinely used by custody banks, such as State Street, to safely manage variable amounts of deposit inflows from institutional investor clients, without introducing greater risk to the client, to the custody bank or to the financial system as a whole. Furthermore, while we do not, as a conceptual matter, support extensive reliance on leverage-based measures of capital in prudential regulation, we accept the existence of the Basel III leverage ratio as a global minimum standard, and believe that if a leverage ratio surcharge is to be implemented by the Basel Committee, it should be structured on a tiered basis according to each G-SIB's risk-based capital surcharge. This is designed to preserve a level playing field among the G-SIBs, maintain the complementary relationship between risk-based and leverage-based measures of capital, and as a means of addressing important differences in industry business models.

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"), and is one of the eight US BHCs which has been designated as a G-SIB. As such, we are subject to a number of enhanced prudential standards foreseen in the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"). This includes a leverage ratio requirement, the enhanced supplementary leverage ratio ("eSLR") that is twice the minimum Basel III leverage ratio requirement of 3% of Tier 1 capital; specifically 5% of Tier 1 capital at the level of the BHC and 6% of Tier 1 capital at the level of each bank subsidiary.¹ 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 CET 1 ratio was 12.5%. Our estimated *pro forma* supplementary leverage ratio equaled 6.2% at the level of the BHC and 6.4% at the level of State Street Bank and Trust Company, our primary bank subsidiary.

Our perspective in respect of the consultation is broadly informed by our status as one of the world's largest providers of custody services to institutional investor clients, as well as our status as one of only two stand-alone custody banks which have been designated by the FSB as a G-SIB. 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

¹ This also includes Section 171 of the Dodd-Frank Act, also known as the 'Collins Amendment', which imposes a statutory capital floor on certain US BHCs 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.

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 our total revenue.

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

- Introduction of an adjustment in the Basel III leverage ratio framework for central bank placements that result from the provision of traditional custody services, either in the form of a cap on the amount of central bank placements that are included in 'total exposure', or in the form of a deduction for excess amounts of operational deposits that result from the provision of these services; and
- Implementation of a tiered G-SIB leverage ratio surcharge based upon each G-SIB's applicable risk-based capital surcharge.

We have participated in the development of the responses prepared by various financial services trade groups, notably the joint submission from The Clearinghouse Association, the Institute of International Finance, the Global Financial Markets Association, the Japan Financial Markets Council and the International Swaps and Derivatives Association, and we broadly support the observations and the 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.

INTRODUCTORY COMMENTS

State Street acknowledges the importance of the Basel III leverage ratio framework in strengthening the resilience of large internationally active banks and in improving the stability of the global financial system. In order to promote effective policy outcomes, however, we believe that leverage-based measures of capital, such as the Basel III leverage ratio, must be calibrated to serve as a complement to risk-based measures of capital rather than as a *de facto* binding regulatory constraint. In the specific case of the G-SIBs, this requires an approach which recognizes the varying amounts of additional risk-based capital (between 1% and 2.5% of Tier 1 capital) that each G-SIB must hold based upon an assessment of its individual risk profile and the extent to which its failure could trigger potential systemic risk within the financial system.

Furthermore, in order to address the negative externalities which result from an un-level playing field among industry participants, we believe that it is important for the Basel III leverage ratio to be implemented on a globally consistent basis, with as little national variation as possible. This is especially important in the case of banking entities which have been designated as G-SIBs given the heightened systemic risk which they present, and therefore the specific policy mandates which have been implemented to address these risks. Similarly, we also believe that the Basel III leverage ratio framework must make appropriate accommodations for differences in industry business models and the implications of these differences for systemic risk. This includes the custody bank business model, which centers on the provision of financial services to institutional investor clients and which requires the custody bank to serve as a safe store of value for client cash, particularly during periods of financial market uncertainty. This involves the extensive use of central bank placements, all but risk-free assets that pose no arbitrage risk, cannot be used to leverage other transactions, cannot be netted or compressed through trading activities and cannot be ‘gamed’ using complex internal models.

As currently designed, leverage-based measures of capital such as the Basel III leverage ratio, do not recognize the unique characteristics of central bank placements, which are treated no differently than a commercial real estate loan or other similar higher risk asset, so that client deposit inflows placed at a national central bank have a disproportionate impact on the custody bank balance sheet that bears no resemblance to the underlying economic risk. This disproportionate impact is especially apparent in a period of financial market uncertainty, as institutional investors seek to reduce their risk exposure in a ‘flight to cash’ that results in large inflows of deposits onto the custody bank balance sheet.

We therefore strongly recommend that the Basel Committee consider certain limited changes to the Basel III leverage ratio framework designed to better reflect the particular characteristics and risk profile of various industry business models, such as the custody bank business model,

without undermining the fundamental policy goals of enhancing the stability of the financial system and reducing potential systemic risk.

CUSTODY BANKS AND THE GLOBAL FINANCIAL SYSTEM

As previously noted in our comment letter, custody banks such as State Street, specialize in the provision of financial services to institutional investor clients. The custody bank client base is diverse and includes US mutual funds (“40 Act Funds”) and their non-US equivalents²; alternative investment funds; corporate and public retirement plans; central banks; sovereign wealth funds; insurance companies; 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 European Union (“EU”) Undertakings for Collective Investments in Transferable Securities (“UCITS”) under the UCITS IV Directive, and to EU alternative investment funds under the Alternative Investment Fund Managers 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.

The services offered by custody banks center on the safekeeping and administration of investment assets, and includes access to deposit accounts required to support day-to-day transactional activities. Essentially, custody banks provide the equivalent of checking accounts for institutional investors, used to buy or sell investment securities in diversified portfolios of investment assets, 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 these ways, custody banks play a narrow, but critical, role within the financial system, helping to facilitate access to and the smooth day-to-day operation of the financial markets. Indeed, it is difficult to imagine that pension plans and investment funds, which are central to the accumulation and preservation of retirement income and other sources of long-term savings in the national and global economy, could function without custody banks, through which they safely and securely manage their safekeeping, asset administration and cash-related needs.

Since custody banks maintain the primary operational accounts of their institutional investor clients, they are the recipients of substantial deposit inflows associated with normal course transactional activities. On occasions, these transactional volumes can be significant and therefore result in elevated deposit activity. This includes pay-down dates on asset-backed securities and other fixed income instruments, the processing of large corporate action events and in periods where institutional investors are actively rebalancing their investment portfolios.

² Examples of non-US equivalents include European Union Undertakings for Collective Investments in Transferable Securities (“UCITS”) and United Kingdom non-UCITS Retail Schemes.

Given their crucial role in supporting normal course investment activities, these deposits cannot be removed from the custody bank without the risk of significant disruption to essential payment, clearing and settlement functions. As an example, insufficient client deposit balances have the potential to disrupt the timely settlement of securities transactions, the movement of funds through national payment systems, and the provision of cash margin in support of OTC derivatives transactions. Insufficient funding could also disrupt the routine processing of client redemptions from '40 Act funds and other non-US equivalents, structured for sale to and use by the retail investor community.

Furthermore, custody banks hold deposit balances which reflect each client's underlying investment strategy and anticipated liquidity needs. As an example, deposit balances in '40 Act funds typically increase at the end of each month, during periods of active client investment reallocations and during periods of significant client growth or decline. As another example, emerging market portfolios typically have higher cash balances than other investment portfolios due to the presence of lower trading volumes in various national jurisdictions and the need to account for timing considerations in the execution of foreign exchange transactions in global markets.

While institutional investors will typically seek to invest available cash in order to maximize investment returns, there are occasions where they will leave additional amounts of cash on deposit with their custody bank. This includes residual cash, which is a normal byproduct of the investment allocation process, and in response to factors such as 'market volatility or geopolitical risk that leads mutual funds, sovereign wealth funds, hedge funds, asset managers and similar entities to seek safekeeping for their customers' funds until market conditions stabilize.'³ As such, the importance of the custody banks is even greater during periods of financial market uncertainty, as institutional investors actively reconsider their risk exposures, thus driving elevated levels of deposit inflows with their custody provider. As an example, at the time of the Lehman Brothers insolvency in September 2008, State Street experienced a rapid increase in client deposits of \$53.8 billion, or 36% of our total client deposit base. Similarly, State Street experienced a surge in client deposit balances during the US debt ceiling crises of mid and late 2011, as well as in the days following the impact of Hurricane Sandy on the East Coast of the US in October 2012.

Since the amount of excess cash that institutional investors will hold at any given time will vary, custody banks have historically managed client deposit inflows by placing them with national central banks. This reflects a highly conservative asset-liability management strategy designed to enable custody banks to support their clients' cash-related needs in a safe and secure manner, without introducing additional risk to the custody bank, to the client or to the financial system as a whole. This practice is consistent with the custody bank's objective of providing highly liquid, low-risk banking services which help smooth the day-to-day operations of the

³ 'Where the Money Goes and Why it Matters: The Market and Policy Impact of Reduced Custody Bank Deposit Capacity', Federal Financial Analytics (August 4, 2015), page 5.

financial markets and absorb financial shocks. However, as previously emphasized in our comment letter, leverage-based measures of capital, such as the Basel III leverage ratio, do not account for the particular characteristics and risk profile of national central bank placements. We are therefore concerned that barring appropriate adjustments to the Basel III leverage ratio framework, custody banks will no longer be able to maintain their role as a safe harbor for client cash, particularly in periods of financial market uncertainty.

MARKET AND REGULATORY DEVELOPMENTS IMPACTING LEVELS OF EXCESS CASH

There have been a number of developments over the course of the past several years which have greatly accelerated the flow of excess cash to the custody banks. This includes unprecedented amounts of monetary stimulus, persistent macro-economic uncertainty and the lack of viable short-term investment options for institutional investors. This also includes new regulatory mandates which have not only raised the demand for low risk-assets, but which require institutional investors to hold larger amounts of cash in order to address anticipated liquidity needs. As an example, new rules introduced by the US Securities and Exchange Commission (“SEC”) for money market funds (“MMF”) which will be effective in October 2016, mandate the use of a floating net asset value for all institutional prime and municipal MMFs. This has led both investors and fund sponsors to reassess their reliance on prime MMFs in favor of alternatives, such as government MMFs and bank deposits, which can be used to preserve the safety of principal.⁴ Moreover, the SEC released in September 2015 a series of proposed rules to strengthen the liquidity risk management practices of ‘40 Act funds, including a required three-day liquid asset minimum.⁵ The impact of these and other similar developments can be seen in rising amounts of cash across various categories of institutional investors. As an example, a Bank of America Merrill Lynch survey of fund managers in July 2015 found that ‘cash levels jumped to 5.5% (of total fund assets), the highest since December 2008 when the world was in the midst of a financial crisis sparked by the collapse of Lehman Brothers’.⁶ Similarly, Morningstar estimated that as of September 2015, cash levels held by ‘40 Act funds had risen to 8.75% of total assets.⁷

This has resulted in a substantial increase in levels of cash placed on deposit with the custody banks. As an example, we estimate that there has been a 76% increase in the ratio of client deposit balances to total assets under custody at State Street from year-end 2010, shortly after

⁴ The industry consensus is that between 40% and 60% of the \$1.4 trillion invested in prime MMFs will migrate to alternative investments, which would imply at least \$560 billion of cash for reallocation.

⁵ ‘Open-end Fund Liquidity Risk Management Programs; Swing Pricing; Re-opening of Comment Period for Investment Company Reporting Modernization Release,’ Proposed Rule, United States Securities and Exchange Commission, Federal Register Volume 80, Number 199 (October 15, 2015), page 62274.

⁶ ‘Big Investors are Holding the Highest Amount of Cash Since Lehman’s Collapse’, Julie Verhage, Bloomberg Business (July 14, 2015).

⁷ ‘Pensions, Mutual Funds Turn Back to Cash’, Timothy Martin and Sarah Krouse, Wall Street Journal (January 10, 2016).

the passage of the Dodd-Frank Act, to mid-2015. Similarly, total client deposits at State Street grew by 113% in the period from late-2010 to late-2014. Since these deposits must be invested somewhere and given the custody banks' use of a highly conservative asset-liability management strategy, this has translated into rising amounts of central bank placements. Indeed, in the period from late-2010 to late-2014, State Street's ratio of total central bank placements to total assets increased from approximately 8% to 28%.

At the same time, there are a number of regulatory requirements which have been implemented or proposed since late-2010 which make it far more challenging for the custody banks to support their clients' financial services needs and to serve as a safe store of value for client cash. This includes the Basel Committee's existing and proposed standardized approach for credit risk, which does not recognize the unique characteristics and risk profiles of regulated investment funds, one of the primary categories of clients serviced by the custody banks, thereby resulting in a substantial overstatement of the risk inherent in the day-to-day provision of payment, settlement and asset administration services.⁸ This also includes the Basel Committee's liquidity framework (both the Liquidity Coverage Ratio and the Net Stable Funding Ratio), which takes a highly conservative view of 'operational deposits', the primary funding source of the custody banks, including stringent qualification requirements and supervisory haircuts which are far in excess of those applied to retail deposits, notwithstanding their similar underlying characteristics.⁹

From the perspective of the custody banks, the most significant of these new regulatory requirements involves national implementation of the Basel III leverage ratio framework, notably the US eSLR, as well as reform measures which have indirect implications on required amounts of leverage-based capital. As previously noted in this comment letter, as a US G-SIB State Street must increase its Tier 1 capital by 6% of the amount of placements held at the Federal Reserve Bank and other similar national central banks, even though these placements create all but no risk to State Street or the financial system as a whole, and thus fundamentally do not present the type of concern that motivated the adoption of the Basel III leverage ratio framework. Similarly, changes proposed by the Basel Committee to the credit conversion factor ("CCF") for unfunded commitments in the standardized approach for credit risk, including the low-risk, unfunded commitments that the custody banks provide to regulated investment funds, have the potential to substantially increase 'total exposure', or the denominator of the Basel III leverage ratio.¹⁰ Indeed, estimates from a study by The Clearinghouse Association

⁸ Under the Basel III capital framework, investment fund exposures are treated within the general category of corporate exposures which are broadly defined to encompass 'incorporated entities, associations, partnerships, proprietorships, trusts, funds and other entities with similar characteristics that do not meet the requirements of any other exposure class.'

⁹ Operational deposits are subject to a 25% supervisory haircut under the short-term Liquidity Coverage Ratio and a 50% supervisory haircut under the longer-term Net Stable Funding Ratio. In comparison, retail deposits are subject to a supervisory haircut of either 5% or 10% under both measures of liquidity.

¹⁰ 'Revisions to the Standardized Approach for Credit Risk', Second Consultative Document, Basel Committee on Banking Supervision (December 2015).

indicate that the proposed changes to the CCF for unfunded commitments would decrease the aggregate leverage ratio of the US advanced approaches banks by up to 60 basis points.¹¹

While we recognize that it is the Basel Committee's intention to conduct an assessment of the cumulative impact of the various proposed changes to the Basel III framework, it is not clear to us that the impact of these changes on the Basel III leverage ratio is well understood, thereby risking even broader disruption to the custody banks and their ability to serve as a safe haven for client cash, especially in periods of market uncertainty. As previously explained, even in ordinary financial conditions the challenge of managing excess amounts of client cash in the current market and regulatory environment are substantial. These challenges are, however, even more pronounced in periods of market uncertainty, during which there have historically been large spikes in cash deposit balances. A wide variety of events could lead to a rapid and unanticipated upsurge in excess cash, from changes in monetary policy, to a further debt crisis or renewed period of geopolitical uncertainty. While custody banks have traditionally played a stabilizing role in these periods of financial stress, absent targeted regulatory relief, we are concerned that our ability to serve as a safe store of value for client cash will be jeopardized. The result could be to deepen a financial crisis by depriving the financial system of a natural outlet for excess cash, thereby exacerbating investor strain and market uncertainty.

While there have been suggestions that the problem of excess amounts of cash is temporary and will self-correct over time as interest rates begin to normalize, there is no certainty that in the post-financial crisis era deposit levels will quickly decline, nor is it likely that the custody banks can earn a sufficient return on central bank placements to offset the underlying cost of leverage capital. Furthermore, this assumption also overlooks the role played by the custody banks during periods of financial stress, where there is substantial evidence of price inelasticity.

LONG-TERM IMPLICATIONS FOR THE CUSTODY BANK BUSINESS MODEL

In the face of a sustained increase in excess amounts of client cash, custody banks such as State Street have three options to ensure compliance with leveraged-based measures of capital, such as the US implementation of the Basel III leverage ratio. The first option is to raise additional amounts of Tier 1 capital in order to maintain a sufficient buffer to address often fluid levels of client deposits. The second option is to shift investment strategies to higher-yield assets in order to try and offset at least a portion of the costs of capital required to support excess amounts of client cash. The third option is to shrink the denominator of the Basel III leverage ratio by reducing cash deposits from their clients, the institutional investors whose needs the custody banks are meant to serve.

¹¹ 'Empirical Analysis of BCBS Proposed Revisions to the Standardized Approach for Credit Risk', The Clearinghouse Association (May 2016), page 7.

The reality is that the custody banks need to employ, and have already begun to implement, a mix of these responses. But the first two strategies—raising additional capital and re-evaluating current approaches to the management of balance sheet assets—are impractical and provide only limited relief. The ability of State Street and other custody banks to raise capital is constrained by the reality that holding ever increasing amounts of capital against central bank placements is not a viable economic strategy. Furthermore, exploring ways to increase the rate-of-return on investment assets is limited by business and regulatory constraints on the ability of any bank to materially increase balance sheet risk. This is especially true for the custody banks, which face the business imperative of supporting their clients' custody-related needs by investing in highly stable and liquid assets, capable of meeting client demand for cash as those needs arise.

Thus, by necessity, and contrary to their historical function, custody banks such as State Street are considering or have adopted measures to limit the amount of cash deposits that they accept from their clients. As an example, during the third quarter of 2015, State Street took measures which resulted in a \$30 to \$35 billion decline in total client deposits, or 10% of our total balance sheet assets. This reduction was intentional, not inadvertent. As we explained to our investors during our third quarter corporate earnings call, we are 'moving aggressively' to 'decrease excess deposits on (the) balance sheet' given the requirements of the eSLR.¹² In effect then, it is only by transforming the traditional role of the custody bank by turning away rather than safekeeping client cash that State Street and other custody banks can reasonably plan to operate under leverage-based measures of capital, notably the US eSLR.

As a banking entity long committed to the provision of financial services to our clients, State Street has not taken this decision lightly. But it is necessary to preserve our viability in light of new prudential regulations. The end result is to leave clients with fewer alternatives for the disposition of their cash, an outcome which creates additional risks for both institutional investors and the financial system as a whole. This situation raises serious policy concerns, particularly in a period of market uncertainty. Absent relief, the custody banks' ability to fulfill their traditional role as a safety valve for client cash will be in jeopardy, a result that could deepen or even create a financial crisis, thereby amplifying potential systemic risk.

TREATMENT OF CENTRAL BANK PLACEMENTS

In order to address these particular circumstances, we strongly urge the Basel Committee to carefully consider the appropriate treatment of central bank placements in the Basel III leverage ratio, notably those placements which result from the provision of traditional custody services. There are several potential alternatives that the Basel Committee may wish to consider. The first would involve a cap on the amount of central bank placements that would be

¹² State Street Corporation Q3 2015 Corporate Earnings Call Transcript, Thompson Reuters Street Events (October 23, 2015), page 5.

included in 'total exposure', that is the denominator of the Basel III leverage ratio. This approach would be designed to address in a highly targeted manner the disproportionate impact of leverage-based measures of capital on the custody bank business model. This is because custody banks tend to have much higher levels of central bank placements than other more traditional banks, with extensive retail, commercial and investment banking operations. As an example, the Basel Committee could implement an approach in which central bank placements of up to 10% of 'total exposure' would continue to be included in the Basel III leverage ratio, while central bank placements above that threshold would be excluded.

This approach has a number of positive features. First, the use of a cap would directly address the problem faced by the custody banks; namely the substantial amount of excess client cash within the financial system which is conservatively managed by the custody banks through placements with national central banks. Second, this approach would not increase leverage within the financial system; it would only exclude cash that is shifted from an institutional investor client, through a custody bank to a central bank. Third, since this approach is tied to 'total exposure', it would not provide relief for various types of off-balance sheet exposures, such as OTC derivatives, which feature prominently in regulatory efforts to reduce the level of systemic risk within the financial system. Finally, this approach is designed to self-correct in that the ability to make use of the cap would progressively decline to the extent that changes in monetary or economic policy, and/or reduced levels of geopolitical risk lead to an overall decline in excess amounts of cash within the financial system.

As an alternative to this approach, the Basel Committee could also permit large internationally active banks, such as the stand-alone custody banks, to deduct from their 'total exposure', the amount of 'excess operational deposits' which they hold on behalf of their clients. This could be a pure deduction (for example, all excess operational deposits held) or, alternatively, a more limited deduction based upon a supervisory factor (for example, 50% of all excess operational deposits held). For these purposes, 'excess operational deposits' could be defined as deposits generated by clearing, custody and cash management activities which constitute an 'excess balance' as specified in Paragraph 96 of the Basel Committee's Liquidity Coverage Ratio ("LCR") framework (*i.e.* a balance that could be withdrawn from a banking entity without impacting the ability of that entity to support clearing, custody and cash management activities), provided that the 'excess balance' meets all of the other qualification requirements specified in Paragraphs 94 and 95.¹³ Alternatively, the Basel Committee may wish to consider an approach based on Section 249.4(b)(5) of the US LCR final rule, which requires the exclusion from total operational deposits, any amount which is identified by the banking entity as an 'excess amount'.¹⁴

¹³ 'Basel III: The Liquidity Coverage Ratio and Liquidity Risk Monitoring Tools', Basel Committee on Banking Supervision (January 2013), pages 24-25.

¹⁴ 'Liquidity Coverage Ratio: Liquidity Risk Measurement Standards', Final Rule, Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Federal Register Volume 79, Number 197 (October 10, 2014), page 61528.

This alternative solution also has a number of positive features. To begin with, a deduction based upon 'excess operational deposits' is specifically targeted so as to avoid regulatory arbitrage in that the deposit balance must be tied to clearing, custody and cash management activities, and must also meet all but one of the prescribed qualification requirements. Furthermore, this deduction would be tied to those excess amounts of client deposits that result from the provision of custody-related services which then drive central bank placements, rather than to general amounts of central bank placements held by a banking entity. Moreover, by tying the deduction to the liability-side of the balance sheet, this solution would not seek to distinguish between the relative riskiness of various types of assets, consistent with one of the fundamental tenets of the leverage ratio construct. Finally, by tying the deduction to the liability-side of the balance sheet, this solution would guard against the possibility that banking entities would place other sources of funding at a national central bank in order to try and obtain leverage ratio relief.

G-SIB LEVERAGE RATIO SURCHARGE

Notwithstanding our pressing concerns regarding the outsized impact of leverage-based measures of capital in prudential regulation, we acknowledge the role of the Basel III leverage ratio as a minimum global standard and believe that if a leverage ratio surcharge is to be implemented by the Basel Committee, it should be structured on a tiered basis according to each G-SIB's risk-based capital surcharge. This reflects three considerations. First, since a number of national jurisdictions represented at the Basel Committee have already introduced higher leverage ratio requirements for their G-SIBs, this approach would help preserve a level playing field among those banks which have been identified by the supervisory community as presenting the greatest potential for systemic risk. As such, this approach would help prevent the emergence of competitive disparities among banks that could lead to the over-concentration of financial activities in certain entities subject to less stringent prudential standards.

Second, this approach would help support the Basel Committee's goal of ensuring the existence of a leverage ratio framework that serves as a complement to the risk-based capital framework by recognizing the variable amounts of risk-based capital that each G-SIB is required to hold. Put differently, by adopting a tiered leverage ratio surcharge, the Basel Committee can help ensure that the Basel III leverage ratio remains closely aligned with the actual amount of risk-based capital that each G-SIB is required to hold, based upon an assessment of its individual risk profile. Third, by tying the leverage ratio surcharge to each G-SIB's risk-based capital surcharge, this approach can serve as the basis for addressing the disproportionate impact of leverage-based measures of capital, as described in this comment letter, on the custody bank business model. This reflects the unique characteristics and risk profile of the stand-alone custody banks when compared to other G-SIBs with extensive retail, commercial and investment banking operations, which translates into a risk-based capital surcharge at or near the bottom of the range foreseen by the Basel Committee (between 1% and 2.5% of Tier 1 capital).

There are two ways in which to structure a tiered G-SIB leverage ratio surcharge. The first would involve an increase in required amounts of leverage-based capital for each G-SIB based upon that G-SIB's risk-based capital surcharge. As an example, a G-SIB with a 1% risk-based capital surcharge would be subject to a minimum Basel III leverage ratio requirement of 4% (*i.e.* 3% + 1%), whereas a G-SIB with a 2.5% risk-based capital surcharge would be subject to a minimum Basel III leverage ratio requirement of 5.5% (*i.e.* 3% + 2.5%). The second would involve the implementation of a leverage ratio surcharge set as a percentage of each G-SIB's risk-based capital surcharge. This is consistent with the approach adopted by the United Kingdom where local G-SIBs are subject to an 'additional leverage ratio buffer' set at 35% of their applicable G-SIB surcharge. While we take no position on the appropriate calibration of the leverage ratio surcharge, we note that it is possible for the Basel Committee to adopt an even more conservative factor (for instance 50%) without compromising the core structure of this alternative. As an example, using a 50% conversion factor, a G-SIB with a 1% risk-based capital surcharge would be subject to a minimum Basel III leverage ratio requirement of 3.5% (*i.e.* 3% + .5%), whereas a G-SIB with a 2.5% risk-based capital surcharge would be subject to a minimum Basel III leverage ratio requirement of 4.25% (*i.e.* 3% + 1.25%).

CONCLUSION

Thank you once again for the opportunity to comment on the important matters raised within this consultation. To summarize, while we welcome the Basel Committee's decision to review the design of the Basel III leverage ratio framework, we believe that its approach is too narrow and that it should take the opportunity to consider other aspects of the framework which are problematic and which may unwittingly impact the stability of the financial markets. This includes the treatment of central bank placements, all but risk-free assets which are central to the ability of the custody banks to serve as a stabilizing force in the financial system by accepting and holding variable amounts of deposit inflows on behalf of their institutional investor clients. Indeed, under the existing Basel III leverage ratio framework, central bank placements are treated no differently than a commercial real estate loan or other higher risk asset, so that client deposit inflows which result from the provision of payment, settlement and asset administration services have a disproportionate impact on the custody bank balance sheet. This is especially true in periods of financial market uncertainty as institutional investors seek to reduce their risk exposure in a 'flight to cash', which drives elevated levels of deposits with their custody providers.

Due to the sustained increase in the amount of excess cash within the financial system over the past several years, the custody banks have been forced to dedicate large amounts of their balance sheet capacity to serve their clients' cash-related needs, leaving little room to respond to a further increase in client deposit inflows during another period of financial market stress. In response, the custody banks have out of necessity taken steps to reduce the amount of cash deposits that they accept from their clients, a result that will almost surely have adverse consequences for institutional investors and the stability of the financial system as a whole.

We therefore strongly recommend that the Basel Committee consider the introduction of an adjustment in the Basel III leverage ratio framework for central bank placements that result from the provision of traditional custody services, either in the form of a cap on the amount of central bank placements included in 'total exposure', or in the form of a deduction for excess amounts of operational deposits which result from the provision of these same services. Furthermore, to the extent that the Basel Committee chooses to implement a leverage ratio surcharge, we believe that it should be structured on a tiered basis according to each G-SIB's risk-based capital surcharge, and note that this approach can also be used as the basis for providing relief in leverage-based measures of capital for the custody bank business model.

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