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

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Second Consultative Document – Guidelines for the Identification and Management of Step-in Risk

Dear Sir or Madam:

State Street Corporation ("State Street") welcomes the opportunity to comment on the Basel Committee on Banking Supervision's ("Basel Committee") second consultative document ("second consultation") on the identification and management of step-in risk. Headquartered in Boston, Massachusetts, State Street is a United States ("US") bank holding company 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 $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.[1] State Street provides investment management services through its asset management arm, State Street Global Advisors, which is one of the world's largest bank-owned asset managers. We have been an active participant in the policy debate on the appropriateness of the Basel Committee's step-in risk framework for bank-sponsored investment funds. This includes extensive comments on the Basel Committee's first step-in risk consultation ("first consultation") issued in December 2015. As with our first letter, our comments in this letter focus solely on the application of the Basel Committee's step-in risk framework to the asset management activities of banks, specifically the sponsorship of investment funds.

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[1] As of March 31, 2017.

State Street welcomes the thoughtful manner in which the Basel Committee has considered the feedback received from its first consultation and the resulting changes which have been made to the intended approach. This includes the decision to reconstitute the step-in risk framework as a set of guidelines to help structure a bank's self-assessment of potential step-in risk, the abandonment of the assumption that step-in risk is endemic in all sponsored fund relationships, and the recognition that there are different ways to address step-in related concerns beyond the automatic imposition of a Pillar I capital or liquidity charge.

Nevertheless, we believe that the Basel Committee's revised step-in risk framework still reflects a pronounced misunderstanding of the nature of the relationship between a bank-owned asset manager and its sponsored investment funds, therefore leading to the prospect of an unnecessarily costly and burdensome compliance exercise for what is at best a deeply remote contingent risk. Indeed, as emphasized in our first comment letter, with the exception of certain money market funds at the height of the financial crisis, there is no history of financial support for a bank-sponsored investment fund, and therefore no credible expectation that a bank will step-in to cover investment losses in a sponsored investment fund, or otherwise support an investment fund's assets.

There are, in our view, several changes which the Basel Committee should make to its proposed step-in risk guidance in order to address this concern. They are as follows:

1. <u>Narrow the definition of 'sponsor' in Paragraph 24 of the Second Consultation</u> – As currently defined, 'sponsor' includes any entity which a bank either manages or advises, thereby effectively requiring a bank-owned asset manager to evaluate for the presence of step-in risk in <u>any and all</u> sponsored investment funds. We believe that this definition should be adjusted to <u>also</u> require the presence in an investment fund sponsor relationship, of: (i) material control by the bank-owned asset manager, (ii) an actual or contingent guarantee or other similar credit support, or (iii) an actual or contingent liquidity facility or other similar liquidity support. In our view, a useful definition of the term 'material control' can be found in the US Board of Governors of the Federal Reserve System's second notice of proposed rulemaking on single counterparty credit limits, where a 'counterparty' is defined to include any entity that the counterparty: "(i) owns, controls, or holds with the power to vote 25% or more of a class of voting securities, (ii) owns or controls 25% of more of the total equity, or (iii) consolidates for financial reporting purposes".[2] In effect, our recommendation is designed to address within the definition of 'sponsor' the essential question of the 'nature and degree' of that sponsor relationship, which the Basel Committee only addresses as an indicator of potential step-in risk.[3] In our view, the coherence of the Basel Committee's proposed

[2] 'Single Counterparty Credit Limits for Large Banking Organizations', Notice of Proposed Rulemaking, Board of Governors of the Federal Reserve System, Federal Register, Volume 81, Number 51 (March 16, 2016), pages 14331-14332.
[3] See Basel Committee Second Consultation, Section 3.1.

framework, would be greatly enhanced if the 'nature and degree' of sponsorship were treated not as a simple structural indicator of potential step-in risk, but rather as a defining metric in the identification of the scope of sponsored investment funds subject to the self-assessment process.

2. <u>Add a new paragraph to Section 2.2.4 of the Second Consultation for investment fund entities</u> – In Section 2.2.4 of the second consultation, the Basel Committee addresses certain features of several types entities, designed to clarify the extent to which these entities should be subject to the self-assessment process for step-in risk. This includes insurance entities, securitization entities and commercial or operational entities. We strongly recommend that the Basel Committee also use this section of its proposed guidelines to clarify the types of sponsored investment funds which can also be pre-emptively excluded from a bank's self-assessment of step-in risk. This includes both passive and index investment funds designed to track the performance of a broad-based market index, such as the S&P 500 or the MSCI Europe.[4] Furthermore, this should also include heavily regulated and widely held investment fund products which are easy to value and freely redeemable, such as US mutual funds and European Union Undertakings for Collective Investments in Transferable Securities. Moreover, we strongly oppose the assertion in Paragraph 23 of the proposed guidance that all 'investment funds….described in Annex 2', including mutual funds and exchange traded funds, should be assessed for the presence of step-in risk. Again, this reflects what we view as an unnecessarily expansive view of the scope of potential step-in risk in an investment fund sponsor relationship, and therefore the prospect of a disproportionate compliance program for bank-owned asset managers with little to no practical benefit.

3. <u>Clarify the scope of the 'collective rebuttal' standard found in Paragraph 30 of the Second Consultation</u> – As currently defined, the 'collective rebuttal' standard is only available to banks to narrow the scope of their self-assessment process for sponsored funds to the extent that sponsor support is 'explicitly prohibited' by 'law of regulation'. While we recognize the concerns which the Basel Committee may have regarding the potential for abuse of the 'collective rebuttal' standard, we believe that this approach is overly conservative, and as such, fails to account for the broad range of regulatory prescriptions and supervisory expectations which define the relationship between a bank and its sponsored investment funds. This includes, for instance, explicit commitments made by a bank to its supervisors in the context of its recovery and

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[4] Although passive and index funds are noted by the Basel Committee in Section 3.5 of the Second Consultation as a counter-example of entities with limited 'liquidity stress or first mover advantage', we believe that it is more appropriate for these investment fund types to be pre-emptively excluded from the self-assessment process for step-in risk.

resolution planning efforts and in its annual stress-testing program, not to provide financial support to a sponsored investment fund or other unconsolidated entity.[5] Recognizing, however, the inherent complexity of trying to define a 'collective rebuttal' standard which can be applied across the financial system globally, we recommend that the Basel Committee specify in its final step-in risk framework that supervisory authorities are encouraged to issue their own guidelines clarifying the scope of and use of the 'collective rebuttal' standard in their national jurisdiction. This clarification would presumably include the criteria noted in Paragraph 30 of the second consultation, informed by an assessment of various 'regulatory restrictions and mitigants' described, at least in part, by the Basel Committee in Section 3.11 of the second consultation. For instance, this would include Sections 23A and 23B of the Federal Reserve Act of 1933 (as amended), which creates a *de facto* limit on the potential exposure of a bank to any one and to all of its affiliates, including sponsored investment funds, as described by the Basel Committee in Section 4.2.5 of the second consultation.[6]

More broadly, we recommend that the Basel Committee specify in its final guidelines that barring a specific and clearly articulated supervisory concern, the self-assessment of step-in risk is intended to apply at the highest level of consolidation. This is designed to avoid the potential for multiple and over-lapping requirements applied by individual jurisdictions using disparate standards for identifying and responding to potential instances of step-in risk, in a manner that would substantially raise the complexity of compliance with little to no practical benefit.

Thank you once again for the opportunity to comment on the important matters raised within the second consultation. To summarize, while we welcome the significant progress which the Basel Committee has made in defining an appropriate framework for the assessment of step-in risk, we continue to believe that the intended approach reflects an inaccurate understanding of the relationship between a bank-owned asset manager and its sponsored investments funds, leading, in turn, to the potential application of an unnecessarily burdensome and costly compliance framework. We therefore recommend a series of targeted adjustments to the proposed guidelines before their issuance in final form.

This includes a narrower definition of the term 'sponsor' which incorporates key elements of the 'nature and degree' of the investment fund sponsor relationship as described in Section 3.1 of the second consultation, a new paragraph in Section 2.2.4 of the second consultation which defines various types of sponsored funds which can pre-emptively be excluded from the self-assessment of step-in risk, and confirmation in Paragraph 30 of the second consultation that supervisory authorities should issue guidelines specifying the scope of the 'collective rebuttal'

[5] Large internationally active US banks are subject to detailed recovery and resolution planning requirements derived from Section 165(d) of the Dodd Frank Wall Street Reform and Consumer Protection Act, as well as the Federal Reserve Board's annual comprehensive capital analysis and review ("CCAR") program.

[6] Section 23A of the Federal Reserve Act limits a bank's exposure to any single affiliate, including a sponsored fund, to no more than 10% of the bank's capital stock and surplus, and a bank's exposure to all of its affiliates combined, including sponsored funds, to no more than 20% of the bank's capital stock and surplus.

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standard in their national jurisdictions. Finally, we recommend clarification by the Basel Committee that the self-assessment of step-in risk is applicable at the highest level of consolidation.

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

Sincerely,

Stefan M. Gavell