September 20, 2013

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

Via e-mail: baselcommittee@bis.org

Consultative Document – Revised Basel III Leverage Ratio Framework and Disclosure Requirements

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 the framework for the Basel III leverage ratio (“leverage ratio”) and associated disclosure requirements. The leverage ratio was introduced as an international standard in December 2010 and is intended to be implemented as a minimum Pillar I requirement as of January 1, 2018.¹ This Consultation seeks to clarify the measurement of certain exposures in the leverage ratio, including the scope of regulatory consolidation, the treatment of derivatives transactions and the treatment of both agency and principal securities financing transactions (“SFT”). In addition, the Consultation specifies reporting and disclosure requirements. Public disclosure of the leverage ratio is effective as of January 1, 2015.

Headquartered in Boston, Massachusetts, State Street specializes in providing institutional investors with investment servicing, investment management and investment research and trading. With $25.74 trillion in assets under custody and administration and $2.15 trillion in assets under management, State Street operates in 29 countries and in more than 100 geographic markets.² State Street is organized as a United States (“US”) financial holding

² As of June 30, 2013.
company, with operations conducted through several entities, primarily its wholly-owned bank subsidiary, State Street Bank and Trust Company.

Our perspective in respect of the Consultation reflects our status as a large, internationally active bank subject to the Basel II advanced approach, and our status as one of the world’s largest providers of global custody services. As a global custody bank, we maintain on behalf of our institutional investor clients an extensive network of sub-custodian and correspondent bank relationships, as well as direct and indirect links with financial market infrastructure in order to facilitate the management of investment assets. Our clients include US mutual funds, and other similar foreign collective investment funds; alternative investment funds; corporate and public retirement plans; sovereign wealth funds; insurance companies; foundations and endowments. We are a major provider of agency SFT on behalf of our institutional investor clients, a well-established financial activity that is subject to stringent prudential regulation.

We appreciate the opportunity to offer insight relative to the impact of the Consultation on our role as a custodial intermediary, a role that is widely understood by market participants 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 supports the introduction of a uniform and robust leverage ratio as a means of strengthening the resilience of internationally active banks and the overall stability of the global financial system. In our view, however, this requires an approach that is carefully calibrated on the basis of clear empirical evidence, that avoids unnecessary volatility in regulatory capital measures, and which acts as a complement to risk-based capital requirements rather than as a de facto binding regulatory constraint.

While we acknowledge the Basel Committee’s efforts to ensure a level playing field among internationally active banks that may be subject to differing national accounting standards, we note that global consistency does not necessarily require the calculation of exposures on a gross basis. Indeed, there are cases where the use of netting in the measurement of exposures may be the most appropriate alternative, and we encourage the Basel Committee to create a flexible approach that carefully reflects both policy goals and the economic reality of varying securities transactions.

While we welcome the Basel Committee’s efforts to clarify the methodologies that must be used when calculating certain on- and off-balance sheet exposures, we believe that there are aspects of the intended approach that lack proportionality and that may therefore benefit from further refinement. We also believe that the intended approach is likely to introduce unwarranted levels of volatility in the measurement of exposures, and that careful consideration should therefore be given to certain adjustments that may help mitigate this concern.
We have participated in the development of the detailed responses submitted by various financial services trade groups, particularly the joint letter from the Global Financial Markets Association, the American Bankers Association, the Financial Services Roundtable, the Institute of International Bankers, the Institute of International Finance and the International Swaps and Derivatives Association (“ISDA”), and the letter from The Clearing House Association, 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 resulting from our custody bank business model.

**TREATMENT OF AGENCY SECURITIES FINANCING TRANSACTIONS**

The Basel Committee draws an important distinction within its proposed framework between the exposure measure for a bank acting as principal in an SFT and the exposure measure for a bank acting as agent when that agent provides a client indemnification or other similar guarantee. More specifically, banks acting as agent in an SFT are permitted to measure their counterparty exposure as ‘current exposure’, or the difference between the value of the security placed on loan and the value of the collateral received, provided that the bank is not otherwise economically exposed to the underlying security or cash in the transaction.

We strongly welcome and support this distinction, which in our view properly accounts for the particular risk inherent in agency-indemnified SFT, a financial activity characterized by and subject to well-developed risk controls. This includes the over-collateralization of securities loans with cash or other high-quality assets, the daily marking of loan positions to market, and the re-margining of loans as appropriate to ensure ongoing over-collateralization. Indeed, we believe that it may be advisable for the Basel Committee to consider the proposed treatment of agency-indemnified SFT as the basis for other regulatory initiatives, notably the ongoing effort to create a framework for the measurement and control of large exposures, where the proposed use of the Basel II Comprehensive Approach for SFT would result in a significant overstatement of risk.³

Notwithstanding our support for the use of the ‘current exposure’ methodology, we note that there are several technical matters that would benefit from further clarification. First, we would ask the Basel Committee to confirm that the reference in footnote 23 of the Consultation relative to limitations on the ability of agent lenders to ‘manag(e) unsegregated collateral, cash or securities’ is not intended to prevent the well-established industry practice of using omnibus accounts to hold segregated client collateral (i.e. collateral that is held apart from the bank’s proprietary assets).⁴ Banks that provide agent lending services routinely use omnibus accounts to hold segregated client collateral in order improve operational efficiencies and reduce costs.

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⁴ Basel Committee Consultative Document; paragraph 39.
We believe that it would be unreasonable to prevent their use in the context of the Basel Committee’s approach, provided that client collateral is properly segregated from the bank’s proprietary assets.

Second, we urge the Basel Committee to clarify that the standard industry practice of providing pre-determined income (“PDI”) to agent lender clients does not constitute an additional economic exposure that would otherwise preclude the use of the ‘current exposure’ methodology for agency-indemnified SFT. In order to improve operational efficiencies and enhance the management of cash, agent lenders offer their clients income payments on securities which have been placed on loan over record date. PDI services are offered on contractual terms and include provisions that allow agent lenders to retrieve or ‘claw-back’ income payments made to client accounts in the event of the non-payment of income by the issuer. The lending agreements between agent lenders and counterparty borrowers obligate the counterparty to pay the agent lender, on behalf of the client, the equivalent of the income received on securities which have been placed on loan. The indemnification that agent lenders provide their clients typically includes the income due on loaned securities.

As a result, there may be limited circumstances in which the ability to ‘claw-back’ income payments would not apply. More specifically, in the event of a borrower default, the agent lender would assume financial responsibility for any shortfall on the income due by the counterparty borrower, rather than exercising a claw back right. Although an additional risk consideration for agent lenders, it is essential to note that PDI does not result in further exposure to the ‘underlying security or cash in the transaction’. In addition, the sums involved in such potential circumstances are quite small and are routinely offset by the overcollateralization of securities placed on loan, including the use of daily re-margining to account for changes in market value. Furthermore, PDI is reflected in an agent bank’s risk-based capital via an appropriate Pillar II operational risk charge. We therefore strongly urge the Basel Committee to clarify that the PDI programs offered by agent lenders do not prevent the use of the ‘current exposure’ methodology in the measurement of agency-indemnified SFT.

**TREATMENT OF NETTING IN THE LEVERAGE RATIO**

The Basel Committee proposes to significantly limit the ability of internationally active banks to make use of netting when calculating their exposures to both derivatives transactions and SFT undertaken on a principal basis. Specifically, for derivatives transactions, the Basel Committee proposes to disallow the netting of collateral, and would also require banks to aggregate the value of collateral provided and collateral received. In the case of principal SFT, the Basel Committee proposes to eliminate the netting of cash payables and cash receivables, so that a bank’s exposure would be measured on the basis of gross SFT exposures.

While we acknowledge the Basel Committee’s efforts to eliminate differences in global accounting standards that may impact the measurement of the leverage ratio, we believe that the intended approach is unduly conservative and also overlooks the economic substance of...
the underlying transactions. More specifically, the Basel Committee’s approach ignores the crucial role played by legally enforceable master netting agreements in limiting the scope of counterparty exposure. This includes the ability to engage in the close-out netting of collateral in the event of counterparty default. We note, in this respect, that legal opinions have been obtained by the industry in over 50 separate jurisdictions that confirm the enforceability of close-out provisions in master netting agreements written in conformance with standards prescribed by ISDA. As such, a bank’s exposure to derivatives transactions and SFT undertaken on a principal basis is limited to the net fair value of all positions held with each of its counterparties, and bears no resemblance to exposures calculated on a gross basis.

Although less common than agency SFT, custody banks such as State Street do offer principal SFT services to their institutional investor clients. This reflects limitations in the ability of buy-side investors to directly access SFT programs, and therefore the need to rely on their custody bank provider or other intermediary in support of their investment activities. The ability to net receivables and payables with our clients is an important consideration in allowing us to offer this service in a scalable and cost effective manner. In order to qualify for treatment on a net basis, SFTs must meet certain requirements that extend beyond execution in accordance with the terms of a master netting agreement. This includes the presence of the same maturity dates, as well as settlement of the underlying transactions on a net basis. When taken in combination, these requirements eliminate the possibility that there could be an unwind event that would force the on-balance sheet treatment of the underlying SFT exposures. These requirements also greatly diminish the possibility of a material liquidity event due to either systemic or idiosyncratic stress.

Moreover, we are concerned that the Basel Committee’s approach may undermine the broader policy goal of encouraging the use of central clearinghouses (“CCP”) for the mitigation of systemic risk. This is particularly true in the context of OTC derivatives, where the G-20 has committed to transition a significant portion of the market to a standardized, centrally-cleared model. This is also true in the case of repurchase transactions, where access to central clearing is valued by many market participants in order to reduce counterparty risk, enhance the transparency of the settlement process and improve access to real-time market data. Among the most significant economic benefits of central clearing is the capacity to net underlying market transactions which have been novated to the CCP. This includes transactions entered into by end-users and buy-side investors who are not generally in a position to become a direct member of a CCP. We are therefore deeply concerned that the Basel Committee’s approach may unwittingly undermine the ability of banks to provide their clients with beneficial access to CCPs globally.

In order to address these concerns, we urge the Basel Committee to consider two modifications to its intended approach. First, with respect to principal SFT, we recommend that the Basel Committee recognize the netting of cash payables and cash receivables for transactions undertaken pursuant to a legally enforceable master netting agreement, provided that the transactions have the same maturity dates, that they are secured by cash or other highly-liquid
collateral, and that they are subject to settlement on a net basis. Second, we urge the Basel Committee to also permit the use of netting for the exposures of banks to derivatives transactions and principal SFT in cases where those transactions are centrally cleared via a qualifying CCP. In order to ensure adequate transparency and the ability to compare the exposure of banks across national jurisdictions, this exemption would not extend to the public disclosure and reconciliation requirements foreseen by the Basel Committee. This includes the use of a common disclosure template and explanatory table.

CUSTODY BANKS AND THE LEVERAGE RATIO

Global custody banks, such as State Street, provide institutional investor clients with a broad range of financial services associated with the safekeeping and administration of investment assets. This includes access to the global settlement infrastructure in order to complete the purchase or sale of securities. This also includes various asset servicing and cash management functions, such as the receipt of income and other interest payments, foreign currency transactions, the facilitation of client subscriptions and redemptions, and other routine transactional activities. Custody banks therefore play an important role in facilitating access to and the smooth operation of financial markets. This is encouraged by supervisory authorities as a way of avoiding bottlenecks that would otherwise hamper market efficiency and exacerbate potential systemic risk.

Custody banks maintain robust systems to monitor and control the extent of their credit exposure to institutional investor clients. This includes policies and procedures adopted in accordance with national prudential regulation. While nearly all client transactions settle as expected, there are occasions where a transaction may be delayed or fail due to timing, matching, systems or other operational impediments. Since these exposures typically arise due to unexpected matters and are generally only apparent late in the business day, it is beyond the ability of custody banks to immediately eliminate or otherwise reduce their effect.

Moreover, there are occasions where transaction volumes can be significant. This includes paydown 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. Although almost always short-term, custody-related activities can therefore be subject to periods of material volatility that may impact measures of regulatory capital, particularly risk-insensitive measures like the leverage ratio.

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5 Highly-liquid collateral can usefully be defined as assets meeting the criteria for treatment as a Level 1 asset in the Basel III Liquidity Coverage Ratio; namely marketable securities guaranteed by sovereign entities which are assigned a zero percent risk-weight under the Basel II Standardized Approach, which are traded in active and liquid financial markets, which have a proven track record as a reliable source of liquidity, and which do not represent obligations of a financial entity, ‘Basel III: The Liquidity Coverage Ratio and Liquidity Risk Monitoring Tools’, Basel Committee on Banking Supervision (January 2013), paragraph 50.
Global custody banks hold the primary operational accounts of institutional investors used in the management of large and diversified global investment portfolios. As a result, global custody banks, such as State Street, tend to experience significant ‘flight to cash’ during periods of financial market stress as institutional investors seek to reduce their risk exposures. This can result in large spikes in client deposits and therefore significant volatility in on-balance sheet assets. As an example, in the days following the Lehman Brothers insolvency in September 2008, State Street experienced a rapid increase in client deposits totaling $53.8 billion, or 36% of our total client deposit base. Similarly, during the US debt ceiling crisis of late-2011, client deposits surged by $27.9 billion, representing an 18% increase in total client deposits, from already elevated levels associated with general financial market stress.

We believe that it is important for the Basel Committee to acknowledge this ‘flight to cash’ phenomenon, as well as the volatility that can accompany payment, clearing and settlement activities generally. In our view, this requires the introduction within the leverage ratio of a ‘safety valve’ that would allow internationally active banks, particularly custody banks, to address unpredictable spikes in client activities without the need for drastic and potentially destabilizing actions, such as the throttling of payment, clearing and settlement functions or the refusal to accept deposit inflows.

We believe that this can best be achieved via the introduction of a targeted adjustment to the exposure measure of on-balance sheets assets for placements held at national central banks in the national currency. Unlike other financial assets, central bank placements are transitory in nature and do not create additional leverage within the financial system. They are also not subject to any decline in their underlying value. Furthermore, the placement of cash at national central banks is consistent with prudent balance sheet management practices, and has been used with considerable success by the industry to address periods of significant market instability and excess liquidity from global quantitative easing since the financial crisis.

Additionally, we urge the Basel Committee to consider the appropriateness of a broader exclusion that would help support the supervisory community’s efforts to improve the liquidity profile of banks globally. Specifically, we believe that there is considerable value in an approach that would also enable banks to exclude from the exposure measure of on-balance sheets assets Level 1 HQLA held for purposes of compliance with the Liquidity Coverage Ratio (“LCR”). Since these assets are held to meet minimum levels of required liquidity, they are not otherwise available to support a bank’s general financing needs. They also have no impact on the level of available equity capital. Most importantly, this approach is consistent with the prudential goal of incentivizing banks to hold greater, rather than lesser, amounts of highly-liquid assets.

**UNREALIZED GAINS AND LOSSES ON AFS SECURITIES**

While general measures of exposure, such as the Basel large exposure regime and the leverage ratio, can serve as useful complements to risk-based capital requirements, they tend to be
subject to high degrees of volatility. This reflects their inherent insensitivity to underlying risk. We therefore believe that the Basel Committee should carefully review elements of the intended approach that may introduce unwarranted volatility.

In particular, we believe that the Basel Committee should carefully assess the significant implications of the treatment of unrealized gains and losses on available for sale (“AFS”) securities. Notwithstanding the pressing concerns raised by the financial industry, the Basel III Accord requires internationally active banks to deduct all unrealized gains and losses on AFS securities from the capital numerator. Since banks subject to the Basel II advanced approach are already required to hold Pillar I capital for their AFS securities to reflect credit risk, and Pillar II capital to reflect net interest rate risk, this approach has the potential to lead to a significant ‘double counting’ of capital. This is especially true in a rising interest rate environment or during periods of financial market stress, where mark-to-market losses can be substantial and can broadly diverge from the actual performance of the underlying assets. The elimination of the regulatory filter for unrealized gains and losses on AFS securities is therefore highly pro-cyclical, resulting in substantial capital volatility at precisely the wrong time in the interest rate cycle or crisis event.

To mitigate the effects of this volatility, internationally active banks will be compelled to hold significant amounts of capital above their already robust core ratios to serve as a buffer against changes in market value. This is especially true in the case of custody banks that make very few loans and are therefore unable to broadly benefit from the held-to-maturity treatment that applies to loan assets. In effect then and notwithstanding their inherently more conservative risk-profile, custody banks are disproportionately affected by the regulatory capital treatment of AFS securities, including in the context of the leverage ratio.

In order to address this concern, we strongly recommend that the Basel Committee consider the reintroduction within the leverage ratio of a regulatory filter for unrealized gains and losses on AFS securities. According to the Basel III Accord, the leverage ratio is intended to function as a simple, transparent and non-risk based supplement to risk-based capital requirements, designed to limit the build-up of leverage within the financial system.6 We therefore believe that it makes little sense to incorporate within the leverage ratio a risk-adjusted numerator that reflects the impact of market changes in the value of AFS securities. This is particularly true for unrealized gains and losses associated with interest rate rather than credit risk factors.

At a minimum, we therefore recommend that the Basel Committee consider the merits of a revised regulatory filter that captures changes in the value of AFS securities that primarily relate to interest rate considerations. A useful approach, in this respect, are the standards prescribed by the Basel Committee for HQLA in the context of the LCR. More specifically, we suggest that the Basel Committee adopt an approach that would permit banks to exclude unrealized gains and losses on AFS securities that meet the definition of a Level 1 asset, as well as certain Level

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2A assets that represent marketable securities guaranteed by sovereign entities which are assigned a twenty percent risk-weight under the Basel II Standardized Approach, which are traded in active and liquid financial markets, which have a proven track record as a reliable source of liquidity, and which do not represent obligations of a financial entity.7

CONCLUSION

Thank you once again for the opportunity to comment on the matters raised within this Consultation. To summarize, we welcome the Basel Committee’s efforts to clarify the methodologies that internationally active banks must use when calculating certain on- and off-balance sheet exposures for the purposes of the leverage ratio. This includes the distinction drawn between methodologies for agency vs. principal SFT. We nevertheless believe that certain adjustments and clarifications to the intended framework are warranted.

This includes confirmation that the requirements in respect of agency-indemnified SFT do not preclude the use of omnibus accounts to hold segregated client collateral or the use by agent lenders of PDI programs. This also includes the ability to net cash payables and cash receivables for certain principal SFT, the introduction of a carve-out for placements held at national central banks in the national currency, and the reintroduction of a regulatory filter for unrealized gains and losses on AFS securities, particularly for valuation changes that primarily reflect interest rate considerations.

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

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