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**Joint Notice of Proposed Rulemaking – Enhanced Supplementary Leverage Ratio Standards for Certain Bank Holding Companies and their Subsidiary Insured Depository Institutions**

Dear Sir/Madam:

State Street Corporation (“State Street”) welcomes the opportunity to comment on the joint Notice of Proposed Rulemaking (“joint NPR”) issued by the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System (“FRB”), and the Federal Deposit Insurance Corporation (“FDIC”) (collectively the “federal banking agencies”), revising

the minimum supplementary leverage ratio (“SLR”) for certain bank holding companies (“BHC”) and insured depository institutions (“IDI”) in the United States (“US”). The SLR is derived from the Basel III Accord of December 2010, which introduced for internationally active banks a uniform minimum leverage ratio of 3% of Tier 1 capital, to serve as a backstop to risk-based capital requirements.<sup>1</sup> The SLR has been incorporated into US prudential regulation as a minimum standard for Advanced Approach banks via the joint Final Rule on Regulatory Capital published July 2, 2013.<sup>2</sup>

The joint NPR applies to any US BHC with more than \$700 billion in total consolidated assets, or any US BHC with more than \$10 trillion in assets under custody (“AUC”) (collectively “covered BHC”), and contemplates a significant increase in the minimum SLR (“revised SLR”). Specifically, covered BHCs would be subject to a new leverage buffer of 2% of Tier 1 capital that would increase the minimum SLR to 5% of Tier 1 capital, while the IDI subsidiaries of covered BHCs (collectively “covered company”) would be subject to a ‘well-capitalized’ threshold of 6% of Tier 1 capital. The stated purpose of the revised SLR is to address the risk that the failure of a covered company could pose to the stability of the US financial system. In addition, the federal banking agencies reference a number of other policy goals, such as eliminating the ‘perception’ that certain financial institutions remain ‘too big to fail’ (“TBTf”), and minimizing risk to the FDIC deposit insurance fund (“DIF”) in the event of a bank insolvency.

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. State Street is organized as a US BHC, with operations conducted through several entities, primarily its wholly-owned bank subsidiary, State Street Bank and Trust Company. State Street has among the highest capital levels in the industry, with a Total Capital ratio of 19.1%, a Tier 1 Capital ratio of 16.6%, and a Tier 1 Common ratio of 14.9%. Our US Tier 1 leverage ratio is 6.9%, well-above the ‘well-capitalized’ standard of 5%.<sup>3</sup>

Our perspective in respect of the joint NPR is largely informed by our status as one of eight designated US global systemically important banks (“G-SIB”), as well as our role as one of the world’s largest providers of 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. These clients include US mutual funds and other similar regulated funds; alternative investment funds; corporate and public retirement plans; sovereign wealth funds; insurance companies; foundations and endowments. We appreciate the opportunity to offer insight relative to the impact of the joint NPR on our

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<sup>1</sup> ‘Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems, Basel Committee on Banking Supervision (December 2010), section 152.

<sup>2</sup> ‘Regulatory Capital Rules’, Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation and the Board of Governors of the Federal Reserve (July 2, 2013).

<sup>3</sup> As of June 30, 2013, based on current US general risk-based capital rules.

role as a custodial intermediary, 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 acknowledges the role of the SLR 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 the SLR must be properly calibrated on the basis of clear empirical evidence, and that it should be designed to serve as a complement to risk-based capital requirements rather than as a *de facto* binding regulatory constraint. We support, in this respect, the recent statement of the Basel Committee on Banking Supervision (“Basel Committee”) in its Discussion Paper on balancing risk-sensitivity, simplicity and comparability in the global regulatory capital framework, that ‘a risk-based capital regime should remain at the core of the regulatory framework for banks, supported by...other measures such as a leverage ratio’.<sup>4</sup>

In addition, we believe that it is important for the SLR to be implemented on a globally consistent basis. We are therefore disappointed that the federal banking agencies have decided to propose a broad increase in the minimum SLR for certain US banking institutions outside of the international framework afforded by the Basel Committee. We also have significant reservations regarding the advisability of proceeding with the joint NPR while the Basel Committee is actively considering changes in the methodology for determining the Basel III leverage ratio denominator.<sup>5</sup>

This includes revisions to the exposure measure for derivatives transactions and securities financing transactions (“SFT”) that would significantly restrict the use of netting under US Generally Accepted Accounting Principles, even in the presence of a legally enforceable master netting agreement. Indeed, we are concerned that insufficient attention is being paid to the cumulative impact of changes in the Basel III leverage ratio denominator and changes in minimum SLR ratios, which are likely to amplify negative outcomes, notably the ability of covered companies to offer beneficial financial services to their clients.

Furthermore, we believe that it is important to acknowledge that the SLR is only one element of the prevailing regulatory capital framework for the largest, most interconnected US banking institutions, and that it should therefore not be viewed as a ‘simple’ means of addressing all potential vulnerabilities in the financial system. This includes the ‘perception’ that certain large US banks benefit from an implicit and/or explicit federal backstop that would prevent their

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<sup>4</sup> ‘Discussion Paper – The Regulatory Framework: Balancing Risk-Sensitivity, Simplicity and Comparability’, Basel Committee on Banking Supervision (July 2013), p. 1.

<sup>5</sup> ‘Consultative Document – Revised Basel III Leverage Ratio Framework and Disclosure Requirements’, Basel Committee on Banking Supervision (June 2013).

orderly resolution in the event of insolvency. Indeed, we have strong reservations regarding the advisability of structuring prudential regulation on the basis of public and/or market ‘perception’ of prudential regulation, and also believe that Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”) provides an appropriately rigorous basis for ensuring the orderly resolution of any US BHC and its associated IDI subsidiaries.

As such, we have broad concerns relative to several elements of the federal banking agencies’ intended approach, particularly when considered in tandem with changes to the Basel III leverage ratio denominator. Specifically, we believe that the revised SLR is improperly calibrated, that it fails to recognize the particular business model of custody banks, and that its design introduces unnecessary levels of volatility in the measurement of regulatory capital. The revised SLR therefore has the potential to create significant impediments for global custody banks, such as State Street, in the provision of seamless access by institutional investor clients to core payment, clearing and settlement functions. Nevertheless, we believe that the intended framework can be improved via a limited number of targeted adjustments, without undermining the central policy objective of improving the stability of the US financial system and its largest banking institutions.

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

- Recalibration of the revised SLR to better reflect the business model and risk profile of custody banks, either via a bucketing approach tied to each covered company’s G-SIB capital surcharge or a ‘custody bank’ adjustment;
- Introduction of an on-balance sheet adjustment for placements held at national central banks (and possibly certain high-quality, highly-liquid assets) to serve as a ‘safety valve’ for elevated client deposit inflows;
- Calculation of on-balance sheet assets on a daily average rather than a month-end average basis, to improve the accuracy of minimum SLR ratios;
- Introduction of a regulatory filter for unrealized gain and losses on available for sale (“AFS”) securities, particularly for interest rate related-considerations, to help promote the consistent use of a non-risk adjusted exposure measure.

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

## CALIBRATION OF THE REVISED SLR

### Minimum Leverage Ratios

The federal banking agencies are proposing to significantly increase the minimum SLR applicable to covered companies, including a doubling of the minimum ratio for IDI subsidiaries from 3% to 6% of Tier 1 capital. It is not clear from the joint NPR how the revised SLR has been calibrated, with no evidence of any pre-rulemaking quantitative impact assessment or other empirical foundation. This includes the lack of any data on the cumulative impact of the revised SLR and proposed changes to the Basel III leverage ratio denominator. This also includes an assessment of the impact of the intended ratios on the ability of covered companies to continue to offer essential financial services to their clients.

Notwithstanding the stated intent of the joint NPR, we believe that the minimum ratios are highly arbitrary, and that they have been set so high that the revised SLR will serve as a *de facto* binding regulatory constraint for covered companies rather than as a complement to risk-based capital requirements. This has profound implications for the US financial system, including discouraging further progress by covered companies in the assessment and management of risk, the creation of powerful incentives to engage in financial activities with a higher risk-reward profile, and the creation of a capital structure that discourages US banking institutions from engaging in high-volume, low-risk, low-return, client-driven financial activities.

We note, in this respect, that calibration of the revised SLR should not simply reflect the perceived ability of covered companies to accumulate additional capital, but instead the ability of covered companies to generate a sufficient financial return on that capital to justify its use. If financial returns are inadequate to cover the cost of capital, covered companies face two difficult alternatives. The first is to increase the amount of financial risk taken so as to offset the corresponding increase in the underlying cost of capital. The second is to scale back certain high-volume, low-risk, low-return financial activities, which are disproportionately impacted by capital measures that do not differentiate underlying risk.

This is especially true if the capital measure has been calibrated in such a manner that it serves as a *de facto* binding regulatory constraint. This includes the changes envisioned by the Basel Committee in the measurement of the Basel III leverage ratio denominator, which we anticipate will be incorporated, once finalized, into the US regulatory capital framework. From our perspective as a global custody bank, this includes the ability to offer our institutional investor clients seamless access to day-to-day payment, clearing and settlement functions. This also includes the ability to offer certain discrete financial services, such as the provision of committed lines of funding to US mutual funds and other similar foreign equivalents (“regulated funds”), the provision of committed lines of funding to municipalities and other public sector entities (“municipal entities”), and the provision of centralized clearing for over-the-counter derivatives transactions (“OTC derivatives”) on behalf of buy-side investors.

## Financial Activities Impacted by the Revised SLR

Custody banks provide committed facilities to regulated funds on contractual terms to accommodate routine day-to-day operational matters. This includes unanticipated movements of cash, client redemption activities and the payment of management fees and other expenses. Committed facilities to regulated funds are therefore important for the efficient operation of financial markets. They are encouraged by securities regulators, including the US Securities and Exchange Commission (“SEC”), as a means of enhancing operational liquidity. Regulated funds are subject to ongoing supervision, and must adhere to specific limits on both borrowed funds and leverage. As an example, US mutual funds governed by the Investment Company Act of 1940 (“40 Act funds”) are not permitted to incur indebtedness unless the fund maintains an asset coverage ratio, including borrowed funds, of at least 300%. Committed facilities to regulated funds are either secured by the fund’s assets or are otherwise subject to *de facto* collateralization via a lien or other similar legal arrangement that protects the custodian from credit risk. Committed facilities to regulated funds are assigned a credit conversion factor (“CCF”) of 100%, meaning that they are subject to calculation under the SLR on a full notional basis, irrespective of both normal and peak historic utilization rates.

The primary source of variable rate financing for municipal entities has traditionally been the market for variable-rate demand notes and tax-exempt commercial paper (collectively “variable-rate notes”). Variable-rate notes are used to diversify a municipal entity’s capital structure, manage budgetary expenditures and reduce funding costs. In order to access the variable-rate note market, municipal entities must generally secure a committed bank facility. Municipal entities are viewed as very high-quality counterparties, with stable and predictable revenue flows. US banking institutions, such as State Street, offer committed facilities based on standardized contractual terms which require the bank to purchase any variable-rate notes that remain unsold. Purchased notes convert into term debt of the municipal issuer, a parity obligation that carries a stepped-up interest rate substantially above the rate for municipal debt from the same issuer with the same maturity profile. Banks that receive term debt are free to dispose of the asset in the secondary market, enter into a repurchase transaction, or otherwise use the securities in normal discount window operations. Committed facilities to municipal entities are also subject to a risk-insensitive CCF of 100%.

In support of regulatory demands for the migration of OTC derivatives to a centrally-cleared model, custody banks provide their institutional investor clients with access to a range of derivatives clearing services. Most buy-side investors are not in a position to become a direct clearing member and must therefore rely on intermediaries to facilitate their use of the evolving OTC derivatives infrastructure. This centers on the appointment of the custody bank as clearing agent, generally as a futures commission merchant, and involves coordinated access to global trading platforms, CCPs and trade repositories. In addition to seamless centralized clearing, custody banks offer their clients’ operational efficiencies that enhance the straight-through processing of derivatives transactions, promote the faster detection and resolution of errors, improve the day-to-day control of both collateral and cash, and reduce counterparty credit risk exposure. For non-centrally cleared OTC derivatives, global custody banks also offer

their clients essential services, such as the safekeeping and administration of cash and non-cash collateral.

The economic implications of a poorly calibrated SLR for high-volume, low-risk, low-return financial activities can be severe. As an example, we estimate that committed lines of funding to regulated funds, which have average draw-down rates of 1% and peak historical draw-down rates of less than 10%, would face a potential ten-fold increase in capital-adjusted costs. In the case of committed lines of funding to municipal entities, which have average draw-down rates at or near 0% and peak historical draw-down rates of less than 5%, capital-adjusted costs are expected to almost double. Faced with these sizable increases in cost, covered companies will be forced to make difficult choices relative to the optimal use of their balance sheets, likely resulting in the elimination or significant contraction of financial activities that have become uneconomic.

More generally, we note that the envisioned framework is likely to place covered companies at a significant competitive disadvantage when compared with both large, non-covered US banking institutions and internationally active banks in other national jurisdictions. This is especially true of IDI subsidiaries that will be forced to operate with minimum leverage ratios that are double the prevailing international and US SLR standard. This will invariably cause the migration of financial activities to banks not subject to the revised SLR, as well as to the less-regulated shadow banking sector.

US banking institutions are active competitors in the provision of global custody services for institutional investor clients, and have historically led the sector with the provision of seamless, cost-effective and valued-added solutions. We believe that this leading market position will be placed at risk in favor of non-US banks, and also shadow banking entities, should the federal banking agencies proceed with the introduction of a revised SLR outside of the Basel Committee framework calibrated not as a complement to risk-based capital requirements, but as a *de facto* binding regulatory constraint.

### **Design of the Revised SLR Framework**

In addition to our concerns relative to the absolute increase in the revised SLR, we also have significant reservations regarding the design of the framework which is based on two distinct ratios; a lower 5% threshold for covered BHCs and a higher 6% threshold for IDI subsidiaries. Notwithstanding their common G-SIB label, covered companies are not uniform in terms of size and scope, running the spectrum from mega banks with total on-balance sheet assets of almost \$2.4 trillion, to State Street with total on-balance sheet assets of \$220 billion. State Street's assets represent only 15% of the average combined assets of the other seven US G-SIBs, and we are ranked 97<sup>th</sup> in the world by total assets, on par with many domestic banks.<sup>6</sup> Also, while most US G-SIBs are universal banks with extensive commercial, investment banking and capital markets operations, the list includes several custody banks with very different business models.

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<sup>6</sup> 'Top 150 Banks Worldwide Ranked by Asset Size', The Banker, July 2013.

Global custody banks, such as State Street, are uniquely focused on serving the investment needs of their institutional investor clients. As further described in the section on ‘Custody Banks and the Revised SLR’, this centers on the provision of safekeeping and asset administration services to large and diversified portfolios of investment assets. These portfolios have significant day-to-day operational needs which require access to deposit accounts and cash management services typically performed by IDIs. In certain cases, the use of IDIs is a function of the prevailing regulatory regime, such as the requirements which apply to both US ‘40 Act funds and European Union Undertakings for Collective Investments in Transferable Securities (“UCITS”), which makes it difficult for such funds to conduct operations with non-bank service providers. In other cases, this reflects well-established client preference to hold and manage investment portfolios with banking entities subject to stringent prudential requirements and regulatory oversight.

Global custody banks, such as State Street, therefore conduct virtually all of their financial activities via one or more IDI subsidiary. Moreover, there are broad regulatory prescriptions in place which significantly limit the capacity for banking institutions to use IDI assets to support financial activities in other parts of the BHC. This includes the requirements of Section 23A of the US Federal Reserve Act which establishes stringent limitations on transactions between an IDI and its affiliates. Global custody banks therefore have very focused business models with strong IDI dependencies and very few material non-bank subsidiaries. Global custody banks also do not generally engage in significant trading or other capital markets activities. As such, we believe that the intended use of a higher minimum ratio for IDI subsidiaries effectively penalizes covered companies whose financial activities are centered within one or more bank subsidiary. This includes the inherently low-risk, client-driven business model of custody banks, which does not lend itself to broad reliance on the BHC.

Global custody banks, such as State Street, have balance sheets that are constructed differently than those of most other covered companies with extensive commercial and investment banking operations. Custody bank balance sheets are built around client deposits derived from the provision of core safekeeping and fund administration services. These deposits represent a stable source of long-term funding whose value is monetized by custody banks via the purchase of large and well-diversified portfolios of high-quality investment assets. Unlike other covered companies, global custody banks make few loans and do not engage in the asset securitization process.

Due to the nature of their institutional investor client base, global custody banks have very few insured deposits, thereby significantly limiting the risk that they present to the DIF in the event of insolvency. Indeed, State Street’s ratio of insured deposits to total deposits as of the most recently available reporting period was .32%, significantly below the industry average of 52.5% and the average for IDIs with more than \$50 billion in total consolidated assets of 42.2%.<sup>7</sup> This low level of risk is in fact one of the primary reasons for the legislative requirement of Section

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<sup>7</sup> FDIC – Statistics on Depository Institutions Report (March 31, 2013).



331 of the Dodd-Frank Act that the FDIC incorporate an adjustment for custody banks within its deposit insurance assessment framework.<sup>8</sup>

### **Use of a G-SIB Bucketing Approach**

In order to address these pressing considerations, we strongly urge the federal banking agencies to modify their intended approach by introducing a framework in which covered companies are assigned to a series of minimum SLR buckets based upon their corresponding G-SIB capital surcharge. As noted in the joint NPR, the Basel Committee uses an ‘indicator-based methodology’ for determining the relative risk profile of G-SIBs that reflects five broad characteristics: scope of cross-jurisdictional activities, balance sheet size and composition, financial interconnectedness, organizational and financial complexity and substitutability. Based upon its relative score, each G-SIB is then assigned a capital surcharge of between 1% and 2.5%, rising in increments of .5%.

We believe that there is considerable merit in introducing a similar construct for covered companies since this approach better reflects the risk profile and systemic footprint of individual banking institutions, in a manner consistent with the provisions of Section 165 of the Dodd-Frank Act. Under this approach, the proposed 2% leverage ratio buffer for covered BHCs and the proposed 6% ‘well-capitalized’ threshold for IDI subsidiaries would be replaced with a sliding leverage ratio charge of between 1% and 2.5% over the prevailing 3% minimum SLR. In practical terms, this means that covered companies would face a uniform SLR requirement for BHCs (leverage buffer) and IDI subsidiaries (‘well-capitalized’ threshold) of between 4.0% and 5.5% of Tier 1 capital.

### **Use of a Custody Bank Adjustment**

The federal banking agencies propose the use of AUC as one of two metrics for defining a covered company that is subject to the revised SLR. We believe that this approach significantly overstates the risk of the custody bank business model. Under the Basel Committee’s ‘indicator-based methodology’, AUC represents only 6.67% of a banking institution’s overall G-SIB assessment score. This ratio is expected to further decline, due to the planned introduction by the Basel Committee of a cap on the metric that incorporates AUC (the substitutability metric), based upon the view that substitutability ‘has a greater impact on the assessment of systemic importance than....intended for banks (providing)....asset custody services’.<sup>9</sup>

As such, the federal banking agencies may wish to consider an alternative approach that is designed to more accurately reflect the risk profile of custody banks that conduct most of their financial activities within one or more IDI subsidiary and that represent limited risk to the DIF in the event of insolvency. This would involve clarification that US banking institutions subject to

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<sup>8</sup> Section 331, The Dodd-Frank Wall Street Reform and Consumer Protection Act (July 21, 2010).

<sup>9</sup> ‘Global Systemically Important Banks: Updated Assessment Methodology and the Higher Loss Absorbency Requirement’, Basel Committee on Banking Supervision (July 2013); p. 6.

the revised SLR solely on the basis of AUC (i.e. US banking institutions with more than \$10 trillion in AUC but less than \$700 billion in total consolidated assets), are subject to a uniform minimum SLR (BHC leverage buffer and IDI 'well-capitalized' threshold) of 5% of Tier 1 capital.

## **CUSTODY BANKS AND THE REVISED SLR**

### **Payment, Clearing and Settlement Activities**

Global custody banks provide their 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 investment securities. This also includes various asset servicing and cash management functions, such as the processing of income and other interest payments, tax reclamations, foreign currency transactions, the facilitation of client subscriptions and redemptions, and other day-to-day operational activities. Global 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.

Global custody banks maintain robust systems to ensure the orderly processing of transactions within client investment accounts. This includes highly-integrated custody and accounting platforms, backed by operational policies and procedures adopted in accordance with national prudential regulation. This also includes systems to control the extent of possible credit exposure to the institutional investor client. While virtually 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. These typically arise due to unexpected matters, such as a missing or erroneous trade instruction, and are generally only apparent late in the business day when it is beyond the ability of the custody bank to immediately eliminate or otherwise reduce the exposure.

Moreover, there are occasions where transactional volumes, and therefore deposit flows, can be significant. 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. Heightened volumes are also common at month-end when retirement plans, insurance plans and other similar collective investment funds typically process beneficiary disbursements. Although almost always short-term, custody-related activities can therefore be subject to periods of volatility that may impact measures of regulatory capital, particularly risk-insensitive measures like the revised SLR.

Global custody banks maintain the operational accounts of clients used in the day-to-day management of large and diversified investment portfolios. This includes residual cash, which is a normal byproduct of the investment allocation process and which varies according to the fund's investment mandate and view of financial markets. As a result, global custody banks

tend to experience significant ‘flight to cash’, during periods of financial market uncertainty, as institutional investors seek to adjust their risk exposure or otherwise rebalance their investment allocation. This can, in turn, result in large client deposit inflows and therefore considerable 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 of \$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 deposit balances from already elevated levels associated with general financial market stress. Moreover, State Street is experiencing a comparable increase in client deposit inflows as a result of ongoing uncertainty regarding US fiscal policy and the debt ceiling. In keeping with their short-term nature, State Street has sought to manage these and other similar deposit increases via the placement of cash with national central banks, particularly the FRB.

### **Operational Nature of Custody Deposits**

We are concerned that, as designed, the revised SLR will limit the ability of custody banks to support the seamless management of institutional investor assets. Deposit activity in custody banks occurs within the client’s primary operational accounts and is not intended to generate investment yield. This is reflected, among others, in the pricing of custody deposits well-below prevailing market rates. The operational nature of custody deposits is recognized by the Basel Committee which assigns deposits generated by ‘clearing, custody and cash management activities’ a more favorable draw-down rate of 25% for purposes of the Liquidity Coverage Ratio (“LCR”), 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.’<sup>10</sup> The Basel Committee also notes that a custody relationship involves ‘facilitation of the operational and administrative elements of (safekeeping, reporting and processing of assets) on behalf of customers, in the process of (customers) transacting and retaining financial assets’.<sup>11</sup>

Custody banks cannot, therefore, make the business decision to turn away deposits without risking significant disruption to essential payment, clearing and settlement functions. There are numerous operational considerations that may impact the level of day-to-day client deposit activity and custody banks do not want to be placed in the untenable position of having to try to differentiate between elevated deposit inflows and normal course financial transactions. Indeed, any effort to constrain clients’ access to their operational accounts, including for purposes of managing the leverage ratio, would almost certainly undermine the entire custody

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<sup>10</sup> Basel III: The Liquidity Coverage Ratio and Liquidity Risk Monitoring Tools’, Basel Committee on Banking Supervision (January 2013); paragraph 93.

<sup>11</sup> ‘Basel III: The Liquidity Coverage Ratio and Liquidity Risk Monitoring Tools’, Basel Committee on Banking Supervision (January 2013); paragraph 102.

relationship with significant and long-term reputational implications. Several examples may help to clarify these essential operational links:

- There are differences in the settlement cycles which apply to market transactions according to asset type and national jurisdiction. As an example, US Treasury securities settle on a T+1 basis, whereas US equities settle on T+3. Similarly, non-US equities have settlement cycles that span from T+1 to T+5. Client investment activity can therefore cause temporary fluctuations in deposit balances that may extend for several business days. This is likely to be particularly pronounced during periods of active portfolio rebalancing, including at quarter-end.
- '40 Act funds and other similar regulated funds process capital stock transactions to reflect the purchase or sale of their underlying shares. This activity is often concentrated at month-end as a result of payroll deductions and matching employer contributions into various retirement plans. Capital stock transactions are also impacted by the rotation of plan assets in and out of various investment allocations. Depending upon the scale of the capital stock activity, deposit balances can remain elevated for a period of several days, and in the case of '40 Act funds, are not allowed by regulation to be held away from the fund's custody provider.
- Custody banks maintain on behalf of their clients, deposit accounts for cash margin exchanged in over-the-counter ("OTC") derivatives transactions. This typically involves the execution of a tri-party agreement in which the custody bank holds cash collateral in either a 'client owned' or 'broker-owned' deposit account, depending upon the terms of the underlying transactions and corresponding market value. In the case of '40 Act funds, there are regulatory requirements in place that prevent such collateral from being held by a third-party entity. It is expected that the amount of cash collateral held by custody banks will significantly increase as regulators continue to implement G-20 mandated reforms of the OTC derivatives market.
- Investments in venture capital funds, hedge funds and private equity funds are governed by the fund's legal structure, and are designed to preserve its long-term investment strategy. This includes subscription and redemption terms that may require pre-notification and/or the processing of transactions on certain specified dates, such as month-end or quarter-end. This generally requires the accumulation of investment proceeds at the custody bank until such time as all legal and administrative matters have been concluded and cash has been transferred either in or out of the deposit account. This can at times extend for a period of several days if not weeks.

Any attempt to restrict or otherwise force the transfer of these and other similar operationally-linked deposit flows away from the custody bank in order to manage the leverage ratio would therefore be highly disruptive and could have significant implications for the stability of financial markets. This includes the increased likelihood of failed securities transactions and/or client overdrafts; restrictions on the ability of '40 Act funds and other regulated funds to process normal course capital stock transactions; impediments in the flow of cash collateral in support of the OTC derivatives markets; and interruptions in the processing of capital investments into various alternative investment funds. These are likely, in turn, to raise

important regulatory and legal issues for custody banks, which even if resolved, would place significant strains on client relationships, with broad reputational and franchise implications.

### **Central Bank Placements**

We believe that it is important for the federal banking agencies to acknowledge both the normal fluctuations that can accompany payment, clearing and settlement activities, and the tendency of custody banks to experience ‘flight to cash’ during periods of market instability. In our view, this requires the introduction, within the revised SLR, of a ‘safety valve’ that would allow covered companies, particularly custody banks, to address unpredictable spikes in operationally-linked client deposits without the need for drastic and potentially destabilizing actions, such as the throttling of payment, clearing and settlement functions, or unilateral attempts to contain deposit inflows.

This can, in our view, best be achieved via the introduction of an adjustment to the exposure measure of on-balance sheet 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 distinct from the obligations of the underlying sovereign and are not subject to any decline in 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.

### **Level 1 High-Quality Liquid Assets**

Additionally, we urge the federal banking agencies to consider the appropriateness of a broader exclusion that would help support efforts to improve the liquidity profile of individual banking institutions and financial markets generally. Specifically, we believe that there is considerable value in an approach that would also exclude from the exposure measure of on-balance sheet assets, Level 1 securities held by banks to comply with the Basel III LCR. These are defined by the Basel Committee as marketable securities representing claims on or guaranteed by sovereign entities that are assigned a zero percent risk-weight under the Basel II Standardized Approach, that are traded in active and liquid financial markets, that have a proven track record as a reliable source of liquidity and that do not represent obligations of a financial entity.<sup>12</sup> In keeping with their inherent stability, Level 1 securities are not subject within the LCR to regulatory haircuts or caps.

There are, in our view, several considerations that warrant this particular treatment. First, since internationally active banks are required to meet the minimum liquidity standards of the Basel III Accord on an ongoing basis, LCR assets are not otherwise available to support a bank’s

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<sup>12</sup> ‘Basel III: The Liquidity Coverage Ratio and Risk Monitoring Tools’, Basel Committee on Banking Supervision (January 2013), paragraph 50.

general financing needs. They also have no impact on a banking institution's available equity capital. Second, this alternative would serve as a useful complement to the recommended exemption for central bank placements in the national currency, by providing banks with an appropriate, market-based alternative for the holding of elevated client deposit inflows. Finally and perhaps most importantly, this approach helps to correct one of the key limitations of the revised SLR, which is to dis-incentivize banks from holding low-risk, high-quality liquid assets, which are essential to the efficient operation of global financial markets.

## **VOLATILITY OF THE REVISED SLR**

While general measures of exposure, such as the FRB's proposed single counterparty credit limits and the SLR, 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 federal banking agencies should endeavor to ensure that the revised SLR is properly calibrated as a back-stop measure of regulatory capital. We also recommend that careful consideration be given to aspects of the revised SLR that may introduce unnecessary levels of volatility.

### **Use of Daily Average On-Balance Sheet Assets**

The federal banking agencies propose in the joint NPR that covered companies calculate the revised SLR on the basis of the average of each month-end ratio in the reporting quarter. This includes measures which are subject to daily calculation, notably total on-balance sheet assets. We believe that this approach is suboptimal since it overlooks the volatility that certain covered companies, particularly custody banks, face in their on-balance sheet assets as a result of client activities at period end. In addition, this approach introduces a clear incentive for covered companies to arbitrage the revised SLR by managing down their on-balance sheet assets just ahead of each reporting period. The significance of the choice of the methodology for calculating on-balance sheet assets should not be underestimated. Indeed, State Street often sees increases in client deposit balances at month end and quarter end that can increase total on-balance sheet assets by 10% - 15% when compared to assets calculated on a daily average basis.

In order to address this concern, we strongly urge the federal banking agencies to adjust their intended approach so that covered companies are required to calculate their total on-balance sheet assets for the purposes of the revised SLR on a daily average basis. Other measures which are not currently subject to daily reporting, such as off-balance sheet exposures and capital ratios, would be subject to calculation as prescribed in the joint-NPR, namely on the basis of the average of three month-end balances in the reporting quarter. This approach is designed to strike an appropriate balance between the accuracy of reported ratios and operational complexity.

It is also consistent with other regulatory measures, such as the FDIC's deposit insurance assessment methodology, which relies on daily average total consolidated on-balance sheet assets, combined with the period-end reporting of other metrics (e.g. unsecured debt and Tier 1 capital). While we view our recommendation as both balanced and equitable, we emphasize that a decision to maintain the current period-end calculation methodology would reinforce for custody banks the crucial importance of an adjustment in the measure of on-balance sheet assets for placements held at national central banks, as a means of addressing volatility in client deposit inflows.

### **Unrealized Gains and Losses on AFS Securities**

In addition, we believe that the federal banking agencies should consider in the context of the joint NPR, the significant implications of the treatment prescribed for unrealized gains and losses on AFS securities in the US Final Rule on Regulatory Capital. Notwithstanding the concerns raised by the industry, the Final Rule requires Advanced Approach 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 in risk-based capital 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, US banking institutions will be compelled to hold significant amounts of capital above their already robust risk-based capital 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 will be disproportionately affected by the volatility inherent in the interplay of the regulatory capital treatment of AFS securities, proposed changes to the Basel III leverage ratio denominator and the revised SLR.

In order to address this concern, we strongly recommend that the federal banking agencies consider the use within the revised SLR of a regulatory filter for unrealized gains and losses on AFS securities. As emphasized by the Basel Committee, the SLR is intended to function as a simple, non-risk based complement to risk-based capital requirements, with the goal of limiting the build-up of excessive leverage within the financial system and addressing potential model risk. We therefore believe that the revised SLR should not be structured on the basis of a risk-adjusted numerator that reflects the impact of changes in the market value of AFS securities. This is particularly true for unrealized gains and losses associated with interest rate, rather than credit risk factors.

We therefore recommend that, at a minimum, the federal banking agencies introduce a regulatory filter to address changes in the value of AFS securities that primarily relate to interest rate considerations. As an example, the federal banking agencies may wish to adopt an approach that would permit the exclusion from the revised SLR, unrealized gains and losses on AFS securities that meet the Basel Committee’s definition of a Level 1 asset. In addition, it may be appropriate to exclude certain other assets, such as Agency and government-sponsored enterprise mortgage-backed securities (at least while under the conservatorship of the US Treasury) and high-quality US municipal obligations that meet the criteria specified by the Basel Committee for Level 2A assets. Specifically, this would include marketable securities representing claims on or guaranteed by sovereign entities that are assigned a twenty percent risk-weight under the Basel II Standardized Approach, that are traded in active and liquid financial markets, that have a proven track record as a reliable source of liquidity and that do not represent obligations of a financial entity.<sup>13</sup>

## CONCLUSION

Thank you once again for the opportunity to comment on the matters raised within the joint NPR. To summarize, while we recognize the role of the SLR in strengthening the resilience of US banking institutions and in improving the stability of the financial system, we believe that the intended framework must be structured to serve as a complement to risk-based capital requirements rather than as a *de facto* binding regulatory constraint. Moreover, we have serious reservations regarding the intended calibration of the revised SLR, particularly when combined with envisioned changes to the Basel III leverage ratio denominator. In addition, we believe that insufficient consideration has been given to the particular business model and risk profile of custody banks, and that the calculation of the revised SLR may introduce excessive levels of potential volatility.

These limitations have important implications for the ability of custody banks to continue to provide their institutional investor clients with access to certain high-volume, low-risk, low-return financial activities, such as committed lines of funding to regulated funds, committed lines of funding to municipal entities, and centralized clearing of OTC derivatives, that tend to be disproportionately impacted by risk-insensitive measures like the revised SLR. This is also true of the ability to support day-to-day payment, clearing and settlement functions, particularly during periods of financial market instability. We therefore recommend a series of targeted adjustments to the intended framework designed to address some of its most pressing limitations without undermining the central policy objective of improving the stability of covered companies and the US financial system.

Specifically, we recommend the introduction of a graduated series of minimum SLR buckets calibrated on the basis of the G-SIB capital surcharge applicable to each covered company, or in

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<sup>13</sup> ‘Basel III: The Liquidity Coverage Ratio and Liquidity Risk Monitoring Tools’, Basel Committee on Banking Supervision (January 2013), paragraph 52(a).



the alternative, the differentiated treatment of custody banks that are subject to the joint NPR solely on the basis of AUC. Furthermore, we support the consistent treatment of both BHCs and IDI subsidiaries so as not to unfairly disadvantage custody banks that represent limited risk to the DIF and that conduct most of their financial activities via one or more IDI subsidiary.

We also support the introduction of an on-balance sheet adjustment for placements held at national central banks in the national currency, as well as for Level 1 securities held to comply with the Basel III LCR. Furthermore, we recommend that the federal banking agencies seek to mitigate the inherent volatility of the revised SLR by requiring the calculation of total on-balance sheet assets on a daily average basis rather than on a month-end average basis, and by introducing a full or partial regulatory filter for unrealized gains and losses on AFS securities.

Please feel free to contact me at [smgavell@statestreet.com](mailto:smgavell@statestreet.com) should you wish to discuss State Street's submission in further detail. We believe that it is essential for the federal banking agencies to more carefully consider the particular implications of the intended approach for covered custody banks, and we welcome, in this respect, the opportunity for further engagement relative to our concerns and recommendations.

Sincerely,

A handwritten signature in black ink, appearing to read "Stefan M. Gavell". The signature is fluid and cursive, with a long horizontal stroke at the end.

Stefan M. Gavell