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Legislative and Regulatory Affairs Division
Office of the Comptroller of the Currency
400 7th Street, SW
Suite 3E-218, Mail Stop 9W-11
Washington, DC 20219
E-mail: regs.comments@occ.treas.gov
Docket ID: OCC-2014-0008

Robert de V. Frierson, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20051
E-mail: regs.comments@federalreserve.gov
Docket Number: R-1487 RIN AE-16

Robert E. Feldman, Executive Secretary
Attention: Comments
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429
E-mail: comments@fdic.gov
RIN Number: 3064-AE12

Joint Notice of Proposed Rulemaking – Regulatory Capital Rules: Regulatory Capital, Proposed Revisions to the Supplementary Leverage Ratio

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 (collectively the “federal banking agencies”), revising the

denominator of the supplementary leverage ratio (“SLR”). The SLR was adopted by the federal banking agencies in July 2013 and reflects United States (“US”) implementation of the Basel III Leverage Ratio. The SLR is applicable under US regulation to banking entities subject to the advanced approaches risk-based capital rule. This includes a general minimum SLR requirement of 3% of Tier 1 Capital, and in the case of the eight US banking organizations designated as global systemically important banks (“G-SIB”), an enhanced minimum standard (“eSLR”) of 5% of Tier 1 Capital at the level of the bank holding company (“BHC”) and 6% at the level of insured depository institution (“IDI”). The joint NPR is intended to incorporate within US rulemaking the changes adopted by the Basel Committee on Banking Supervision (“Basel Committee”) to the Basel III Leverage Ratio in January 2014.¹

Headquartered in Boston, Massachusetts, State Street specializes in providing institutional investors with investment servicing, investment management and investment research and trading. With \$27.5 trillion in assets under custody and administration and \$2.4 trillion in assets under management, State Street operates in 29 countries and in more than 100 geographic markets. State Street is organized as a US BHC, with operations conducted through several entities, primarily its wholly-owned IDI subsidiary, State Street Bank and Trust Company. State Street has among the highest capital levels in the industry, with a Total Capital ratio of 20.9%, a Tier 1 Capital ratio of 18.2%, a Tier 1 Common ratio of 16.4% and a US Tier 1 Leverage ratio of 7.4%. Our estimated *pro forma* Basel III advanced approach and standardized approach Tier 1 ratios are 13.2% and 11.1% respectively, and our estimated *pro forma* SLR totals 6.4% at the level of the BHC and 6.0% at the level of the IDI.²

Our perspective in respect of the joint NPR is largely informed by our status as one of eight designated US G-SIBs, as well as our role as one of the world’s largest providers of custody services to institutional investor clients. These clients include asset owners, asset managers and official institutions, and encompass US mutual funds and other similar foreign equivalents; corporate and public retirement plans; sovereign wealth funds; central banks; alternative investment funds; insurance company general and separate accounts; charitable foundations and endowments. We appreciate the opportunity to offer insight relative to the impact of the joint NPR on our 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 importance of a well-calibrated SLR in strengthening the resilience of large and internationally active US banking organizations, and in improving the stability of the financial system. In order to promote effective policy outcomes, however, we

¹ ‘Basel III Leverage Ratio Framework and Disclosure Requirements’, Basel Committee on Banking Supervision (January 2014).

² As of March 31, 2014.

believe that the SLR must operate as a complement to risk-based capital requirements, rather than as a *de facto* binding regulatory constraint. Furthermore, we believe that is important for the SLR to be implemented on a globally consistent basis so as to avoid the emergence of competitive disparities among industry participants. Similarly, we believe that it is essential for the SLR to appropriately recognize the differences which exist in industry business models, including their implications for systemic risk.

As such, we are disappointed by the federal banking agencies' decision to implement substantially higher minimum leverage ratio requirements for a narrow sub-set of US banks, as well as the decision to bifurcate the eSLR standard for BHCs and IDIs. Indeed, we continue to believe that the design and calibration of the eSLR penalizes core aspects of the custody bank business model, including the intermediation of high-volume, low-risk, low-return financial activities and broad reliance on essentially riskless assets, notably central bank placements. Notwithstanding their common label, two of the eight designated US G-SIBs are specialized custody banks, with very different business models and balance sheet structures than their G-SIB peers. Also, the systemic factors that led to their designation as G-SIBs are substantially different than those of large banking organizations with extensive commercial, capital markets and investment banking operations.

Given the stringency of the emerging body of regulation for US G-SIBs, including a doubling of the minimum SLR requirement for IDI subsidiaries, it is critical that the federal banking agencies carefully consider their implications for the custody bank business model. Absent such tailoring, we believe that the federal banking agencies may compromise the ability of custody banks to operate a successful and highly stable business model that helps promote the safety of client assets and the stability of the financial system. Moreover, the migration of custodial services away from specialized custody banks and towards larger and more complex banking organizations, such as the non-custody bank G-SIBs, will increase rather than decrease systemic risk and result in less focus on the unique servicing needs of institutional investor clients.

The federal banking agencies note that revisions to the denominator of the SLR, as foreseen in the joint NPR, 'are designed to strengthen the SLR by more appropriately capturing the exposure of a banking organization's on- and off-balance sheet items'.³ In addition, the federal banking agencies emphasize that the joint NPR seeks to address some of the concerns raised by market participants in respect of the eSLR standard. This includes the concerns of the custody banks relative to substantial volatility in client deposit balances at period-end. Notwithstanding our reservations regarding the design and scope of the eSLR, we agree that the proposed revisions to the denominator of the SLR represent an important step forward in ensuring the emergence of a more globally consistent and better calibrated leverage ratio framework. This includes the ability to net securities financing transactions ("SFT") undertaken on a principal basis subject to certain specified conditions, clarification regarding the measurement of exposures to SFT where the banking organization is acting as agent and offers an indemnity or

³ 'Joint Notice of Proposed Rulemaking: Regulatory Capital Rules: Regulatory Capital, Proposed Revisions to the Supplementary Leverage Ratio', Federal Register Volume 79, Number 84 (May 1, 2014), page 24598.

other similar guarantee (“agency SFT”), the use of standardized credit conversion factors (“CCF”) for the calculation of exposures to unfunded commitments, and the measurement of SLR minimums on a daily average basis. These are important adjustments to the prevailing regime which we strongly support.

Nevertheless, we continue to have pressing concerns regarding the treatment of one major category of exposure within the eSLR, specifically placements held with national central banks. In addition, we would like to offer comment on questions raised by the federal banking agencies relative to the requirement to calculate SLR minimums on a daily average basis, as well as certain observations regarding challenges in the development of centralized clearing for agency SFT.

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

- Introduction of a narrowly defined adjustment in the exposure measure of the eSLR for central bank placements associated with excess amounts of operationally-linked client deposit balances;
- The adoption of the alternative quarter-end approach for the calculation of off-balance sheet exposures in the SLR, or alternatively, the introduction of daily averaging for off-balance sheet exposures on a phased basis;
- Additional clarification regarding the intended exposure measure for agency SFT subject to centralized clearing.

We have participated in the development of the detailed responses submitted by various financial services trade groups, notably the joint letter from the Securities Industry and Financial Markets Association, the Financial Services Roundtable and the American Bankers 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, including those that result from our custody bank business model.

CENTRAL BANK PLACEMENTS

As extensively discussed in our October 2013 comment letter on the eSLR, custody banks such as State Street are uniquely focused on serving the investment needs of their institutional investor clients. These clients contract with custody banks to ensure the proper safekeeping of their investment assets, as well as the provision of a broad range of associated services. This includes access to the global settlement infrastructure in order to complete the purchase or sale of investment securities. This also includes various asset servicing 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 transactional matters. 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.

In keeping with their safekeeping and asset servicing mandate, custody banks maintain the primary operational accounts of their institutional investor clients. As a result, 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. Moreover, custody banks also hold cash balances associated with the prudent management of investment assets. These balances are maintained by clients to address anticipated and unanticipated funding needs stemming from various operational factors, such as failed securities transactions, the non-receipt of payments, timing differences in the movement of cash and client redemption activities.

As a result, custody banks can experience pronounced increases in deposit inflows tied to day-to-day transactional activities, and therefore considerable volatility in on-balance sheet assets. Although most pronounced during periods of financial market uncertainty, such as in the days following the Lehman Brothers insolvency in September 2008 or during the US debt ceiling crisis of late-2011, client deposit balances can vary substantially even in periods of normal financial market activity. For example, at year-end 2013, State Street received excess deposit inflows of \$33 billion above our quarterly average deposit balance of \$150 billion. Again, at the March 2014 quarter-end, we saw excess deposit inflows of \$40 billion above our quarterly average deposit balance of \$155 billion. In keeping with their short-term nature, State Street has sought to manage these and other similar operationally-linked client deposit flows via the placement of cash with national central banks, notably the FRB.

The federal banking agencies acknowledge the issues raised by custody-related deposit flows in the joint NPR, and propose to mitigate its impact on banking organizations by adjusting the methodology for the calculation of the denominator of the SLR from period-end data to the average of daily calculations over the reporting quarter. While we strongly welcome and support this approach, we are concerned that the use of daily averaging will not fully address deposit volatility associated with the day-to-day management of investment assets, as well as ‘flight to cash’ considerations during periods of financial market stress.

Custody deposits are an essential byproduct of the custody business model, which is defined by a series of operational dependencies tied to core transactional activities. These stem from the provision of services under a legally binding written agreement, covering both the safekeeping and the administration of investment assets. The strong operational nature of custody deposits is recognized by, among others, the Basel Committee, which assigns deposits generated from ‘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.’⁴ The classification of custody deposits as operational is conditioned upon meeting a series of stringent qualification requirements, designed to ensure that ‘banks utilizing this treatment actually are conducting these operational activities at the level indicated.’⁵ In the case of US implementation of the LCR, this includes the requirement for banking organizations to implement a ‘methodology for identifying any excess (deposit) amount, which must be excluded from the operational deposit amount’.⁶

In view of these important operational dependencies, custody banks cannot make the business decision to turn away client deposits without risking significant disruption to client investment activities. As previously described, there are numerous considerations that may impact the level of day-to-day deposit balances 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 within individual client accounts. Indeed, any effort to constrain clients’ access to their operational accounts, including for purposes of managing eSLR minimums, would risk undermining the entire custody relationship with significant and long-term reputational implications.

Moreover, any attempt to restrict or otherwise force the transfer of custody deposits away from the custody bank for purposes of managing the eSLR would 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 private investment funds. These are likely, in turn, to raise important regulatory issues for custody banks, which even if resolved, would place significant strains on client relationships, with broad franchise implications.

Although custody banks are well-placed to manage the impact of elevated client deposit inflows at the minimum SLR requirement of 3% of Tier 1 Capital, we believe that the federal banking agencies should acknowledge the particular challenges raised by the much higher minimum ratios specified in the eSLR. This includes the 6% ratio which applies to IDI subsidiaries. As emphasized in the joint industry association response to the proposed rule, the federal banking agencies appear to have the statutory authority to exercise discretion when addressing temporary breaches of eSLR minimums, including during periods of financial market stress. Similar regulatory flexibility is foreseen in US implementation of the LCR, where the federal banking agencies emphasize that ‘Depending upon the circumstances, an LCR shortfall below

⁴ ‘Basel III: The Liquidity Coverage Ratio and Liquidity Risk Monitoring Tools’, Basel Committee on Banking Supervision (January 2013); paragraph 93.

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

⁶ ‘Joint Notice of Proposed Rulemaking: Liquidity Coverage Ratio; Liquidity Risk Measurement, Standards and Monitoring’, Federal Register Volume 78, Number 230 (November 29, 2013), page 71859.

100% would not necessarily result in supervisory action, but at a minimum, would result in heightened supervisory monitoring'.⁷

While we believe that this approach has merit, the federal banking agencies may wish to consider an alternative solution based on an objective set of criteria that does not require a specific regulatory finding and/ or course of action. In our view, this would involve the introduction of a carefully defined 'safety valve', designed to address volatility in client deposit balances resulting from the provision of safekeeping, asset administration and other similar services, without the need for drastic and potentially destabilizing actions, such as the throttling of payment, clearing and settlement activities, or unilateral restrictions on deposit inflows.

More specifically, we suggest the introduction of a 'central bank adjustment' in the exposure measure of the eSLR, tied to excess amounts of operational deposits held by a banking organization resulting from the requirement of Sub-Part A, Section 4 (b) (6) of the US LCR, also referred by the federal banking agencies as 'excess operational deposits'.⁸ Under this approach, a banking organization would be permitted to deduct its excess operational deposits when placed with a national central bank, subject to a standardized supervisory factor and excluding any balances resulting from reserve or other similar requirements. As an example, using a conservative supervisory factor of .5, a banking organization placing \$10 billion at the FRB with an excess operational deposit balance of \$5 billion would be permitted to adjust its eSLR exposure measure by \$2.5 billion, assuming that the \$2.5 billion does not represent, either in whole or in part, required central bank reserves.

The extent of a banking organization's possible leverage would continue to be capped by both the SLR minimum of 3% of Tier 1 Capital and the requirements of the US Tier 1 Leverage ratio. While there are a number of possible avenues for addressing concerns regarding the treatment of central bank placements, and while we are open to alternative approaches that would result in either the full or partial exclusion of such placements from the exposure measure of the eSLR, we believe that our recommendation provides for an appropriately tailored exception tied to client deposit inflows associated with the provision of core custody services, including in periods of financial market stress.

In addition, we believe that this approach would result in a more accurate measure of the economic exposure inherent in central bank placements. The federal banking agencies emphasize in the joint NPR that the introduction of standardized CCFs for unfunded commitments is necessary in the context of the SLR since the measurement of such exposures on a full notional basis 'likely overstates the relative magnitude of the effective economic exposure created by (such) off-balance sheet exposures'. We believe that a similar logic applies in the case of excess operational deposits which have been placed with a national central bank.

⁷ 'Joint Notice of Proposed Rulemaking: Liquidity Coverage Ratio; Liquidity Risk Measurement, Standards and Monitoring', Federal Register Volume 78, Number 230 (November 29, 2013), page 71845-71846.

⁸ 'Joint Notice of Proposed Rulemaking: Liquidity Coverage Ratio; Liquidity Risk Measurement, Standards and Monitoring', Federal Register Volume 78, Number 230 (November 29, 2013), page 71859 and 71841.

Indeed, 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. The requirement to measure central bank placements on a full notional basis, in a manner similar to any other financial asset, is therefore likely result in a highly misleading assessment of risk. Furthermore, the placement of excess amounts of operational deposits at national central banks is consistent with the prudent management of balance sheet risk, and has been used with considerable success by the custody banking industry to address periods of significant volatility in financial markets.

DAILY AVERAGING

The federal banking agencies propose in the joint NPR to revise the existing methodology for calculating the denominator of the SLR. Specifically, banking organizations would be required to conduct daily calculations of both on- and off-balance sheet assets and to assess their SLR exposures on a daily average basis over the reporting quarter. The numerator of the SLR, Tier 1 Capital, would be calculated as of the last day of each reporting quarter. As per our earlier comments, we strongly support the use of daily averaging in the measurement of the SLR, and we agree that this approach provides substantial relief for period and quarter-end volatility in client deposit balances.

In Question 17 of the joint NPR, the federal banking agencies ask for views on an alternative approach in which banking organizations would be required to use daily averaging for the measurement of their on-balance sheet exposures, coupled with quarter-end calculations for the measurement of off-balance sheet exposures. We believe that this alternative approach has considerable merit for two reasons. First, from our experience, the volatility of exposures in off-balance sheet assets is far less significant than on-balance sheet assets, and is therefore unlikely to have a material impact on the SLR that cannot be captured by the use of quarter-end data. Second, the industry has yet to develop operational processes that would permit the daily calculation of certain components of off-balance sheet assets, such as potential future exposure in derivatives transactions, in a streamlined and reasonably cost effective manner. This is particularly true for banking organizations which do not engage in substantial volumes of derivatives transactions. As such, we believe that the alternative approach strikes an appropriate balance between the accuracy of reported minimum ratios and operational complexity.

If the federal banking agencies decide to proceed with the requirement for daily averaging of both on- and off-balance sheet exposures, we suggest the use of a phased implementation approach designed to address the challenges that banking organizations will face in meeting the intended public reporting deadline of January 1, 2015. More specifically, we recommend that the daily averaging of on-balance sheet assets be required as of January 1, 2015, but that the use of daily averaging for off-balance sheet assets be delayed for a period of one year, until January 1, 2016. As such, banking organizations subject to the SLR will have an appropriate

additional amount of time to make the required upgrades to information technology systems and internal processes to support full daily averaging of all measures of exposure.

CENTRALLY CLEARED AGENCY SFT

As noted in our introductory comments, State Street strongly supports the methodology proposed by the federal banking agencies for the measurement of exposures to agency SFT in the SLR. In view of industry practice in the agency SFT market, including the over-collateralization of securities loans with cash or other high-quality assets, the daily marking of positions to market, and the re-margining of loans to ensure ongoing-over-collateralization, we agree that it is appropriate for banking organizations subject to the SLR to net the indemnified total fair value of instruments lent to a counterparty against the total fair value of instruments received from the counterparty for transactions subject to a qualifying master netting agreement, and to recognize any resulting exposure amount greater than zero. While exposures may arise from such transactions, the agent bank lender is unable to create leverage through agency SFT since collateral assets are held off-balance sheet on behalf of the client.

Furthermore, we note the comment in the preamble of the joint NPR that this methodology is also intended to apply to centrally cleared agency SFT.⁹ The use of the same methodology for cleared transactions is an important consideration since it is reasonable to assume that the market will, at least over time, seek to make broader use of centralized solutions for the management of risk exposures. As a practical matter, however, the ability to make use of centralized clearing in agency SFT will be heavily influenced by the treatment of collateral which has been posted to a qualifying central clearinghouse (“QCCP”). More specifically, the lack of an accommodation within the SLR for collateral posted to a QCCP in support of agency SFT may create a disparity relative to the exposure measure of agency SFT undertaken on a bilateral basis.

Under risk-based capital standards, QCCPs are recognized as lower risk counterparties, thereby significantly reducing the fair value of indemnifications in market transactions. The risk reducing benefits of a QCCP extend beyond the counterparties to the transaction, to also include a reduction in systemic risk. Indeed, in the event of a fire sale, the broader use of QCCPs would likely reduce market volatility, and regulatory standards should be constructed to avoid discouraging their usage. As currently drafted, however, the ability to rely on the risk reducing benefits of a QCCP in agency SFT is uncertain, in view of the potential impact of posted collateral on leverage assets. For banks subject to the eSLR, which is likely to be the binding constraint relative to risk-based capital standards for high-volume, low-risk, low-return financial activities, such as agency SFT, this may create a disincentive for the broader use of centralized clearing solutions. We therefore believe that it may be advisable for the federal banking agencies to clarify in the final rule that the ability to net the indemnified total fair value of

⁹ ‘Joint Notice of Proposed Rulemaking: Regulatory Capital Rules: Regulatory Capital, Proposed Revisions to the Supplementary Leverage Ratio’, Federal Register Volume 79, Number 84 (May 1, 2014), page 24602.

instruments lent to a counterparty against the total fair value of instruments received from the counterparty in agency SFT, includes any collateral posted to a QCCP in support of such cleared transactions.

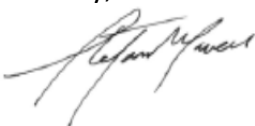
CONCLUSION

Thank you once again for the opportunity to comment on the matters raised within the joint NPR. To summarize, while we recognize the benefits of a well-calibrated SLR, we believe that the federal banking agencies must endeavor to better accommodate the highly stable and low-risk business model of specialized custody banks. Also, while we support the proposed revisions to the denominator of the SLR, we continue to have reservations regarding the treatment of central bank placements in the context of the much higher minimum ratios foreseen in the eSLR. This is especially true in periods of financial market stress, where custody banks such as State Street tend to experience significant 'flight to cash' as institutional investor clients seek to manage their risk exposures. We therefore recommend the introduction of a targeted 'central bank adjustment' in the exposure measure of the eSLR, which would permit the exclusion of certain amounts of excess operational deposits held by a banking organization when placed with a national central bank.

Furthermore, we endorse the alternative approach suggested by the federal banking agencies for the calculation of the SLR denominator, involving the use of daily averaging for on-balance sheet exposures and quarter-end data for off-balance sheet exposures. Alternatively, we recommend the use of a phased implementation schedule, in which the daily averaging of off-balance sheet exposures would be delayed for a period of one year until January 1, 2016. Finally, we note the importance of further clarification regarding the intended treatment of agency SFT subject to centralized clearing.

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