



State Street Corporation

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Ann E. Misback, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551
E-mail: regs.comments@federalreserve.gov
Docket Number: R-1629
RIN: 7100-AF22

Legislative and Regulatory Activities Division
Office of the Comptroller of the Currency
400 7th Street SW, Suite 3E-218
Washington, DC 20219
E-mail: regs.comments@occ.treas.gov
Docket ID OCC-2018-0030
RIN: 1557-AE44

Robert E. Feldman, Executive Secretary
Federal Deposit Insurance Corporation
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RIN: 3064-AE80

**Joint Notice of Proposed Rulemaking – Standardized Approach for Calculating the Exposure
Amount of Derivative Contracts**

Dear Sir/ Madam:

State Street Corporation (“State Street”) welcomes the opportunity to comment on the joint notice of proposed rulemaking (“proposed rule”) issued by the Board of Governors of the Federal Reserve System (“Board”), the Office of the Comptroller of the Currency and the

Federal Deposit Insurance Corporation (collectively the “agencies”), regarding the implementation of the standardized approach for counterparty credit risk (“SA-CCR”) as a new methodology for the measurement of exposures to derivatives transactions in the United States (“US”) regulatory capital framework. This includes the measurement of risk-weighted assets under both the standardized and advanced approaches for risk-based capital, and the calculation of total leverage exposure for purposes of the supplementary leverage ratio. This also includes the measurement of exposures in the Board’s single counterparty credit limit (“SCCL”) final rule. While we appreciate the agencies efforts to develop an alternative standardized methodology for the measurement of derivatives exposures which balances simplicity with improved risk-sensitivity, we do not support the implementation of SA-CCR as defined, and on the timeline prescribed, in the proposed rule.

Headquartered in Boston, Massachusetts, State Street specializes in the provision of financial services to institutional investor clients. This includes investment servicing, investment management, data and analytics, and investment research and trading. With \$31.62 trillion in assets under custody and administration and \$2.51 trillion in assets under management, State Street operates in 30 countries and in more than 100 geographic markets.¹ State Street is organized as a US bank holding company, with operations conducted through several entities, primarily its wholly-owned insured depository institution subsidiary, State Street Bank and Trust Company.

We offer a targeted range of trading and markets solutions to our custody clients through our State Street Global Markets group; primarily principal and agency-indemnified securities financing transactions (“SFT”), portfolio transition management services, and foreign currency (“FX”) transactions undertaken to facilitate client investment activities in non-US markets. Unlike most major dealer banks which trade in tenor buckets of two, five and ten years, State Street’s FX offerings are short-dated, with 60% of our FX trades having less than three months tenor, and 95% having less than one year tenor. Our product offerings are ‘plain vanilla’ (essentially spot, forward and swap FX), and do not extend to more complex products, such as options, swap options, tenured basis swaps and structured solutions. Our market making activities and inventory are limited to what is required to meet our client’s needs, and we routinely lay off excess credit risk to major dealer banks.

As such, we maintain a relatively small and tailored portfolio of client-facing derivatives that is both quantitatively and qualitatively different than the multi-asset class portfolios managed by other banks with extensive commercial, trading and capital markets operations. Furthermore, we do not engage in client clearing activities, or maintain extensive relationships with central clearing counterparties in the derivatives market. Our intention in submitting this letter is to emphasize our strongly held view that the agencies should not adopt SA-CCR as currently defined, including its implementation on a ‘solo’ basis ahead of a broader review of the US regulatory capital framework designed to implement the various components of the Basel III

¹ As of December 31, 2018.

review, as agreed to by member jurisdictions of the Basel Committee on Banking Supervision (“Basel Committee”) in December 2017.

THE CUSTODY BANK BUSINESS MODEL

Custody banks, such as State Street, employ a highly specialized business model focused on the provision of financial services to institutional investor clients rather than the generation of yield from credit risk assets. These clients, which include asset owners, asset managers, insurance companies, official institutions and endowments, contract with custody banks to ensure the proper safekeeping of their investment assets, as well as the provision of a broad range of related financial services. These services include access to the global settlement infrastructure in order to complete the purchase or sale of investment securities; various asset administration functions, such as the processing of income and other interest payments, corporate action events, tax reclamations and client subscriptions and redemptions; and the provision of banking services, notably access to deposit accounts used to facilitate day-to-day transactional activities. The importance of financial services to the custody bank business model can be seen in the large amount of revenue derived from fee-related activities. As an example, in Q4 2018, fee revenue comprised 76.7 % of State Street’s total revenue.

In addition, custody banks have balance sheets which are constructed differently than most banks with extensive commercial, trading and investment banking operations. Indeed, the custody bank balance sheet is liability driven and expands not through asset growth, but through the organic development of client servicing relationships that, over time, translate into increased volumes of highly stable deposits. These deposits, rather than various sources of wholesale funding, provide the largest part of the custody banks’ liabilities. For example, on average, client deposits made up approximately 78% of State Street’s total balance sheet liabilities in Q4 2018. As such, custody banks such as State Street do not rely extensively on various sources of debt to manage their balance sheets or their day-to-day business activities. Importantly, custody banks acquire deposit liabilities as a direct result of the operational services they provide. In other words, the cash deposits that come on to the custody bank balance sheet are driven by customer demand, not by the custody banks’ financing decisions.

We appreciate the opportunity to offer insight relative to the implications of the proposed rule on our role as a custodial entity, a role that is widely understood by the market and by the supervisory community as providing important benefits for the safety of client assets and the stability of the financial system.

SCOPE, APPLICABILITY AND CALIBRATION OF SA-CCR

In order to mitigate the potentially disproportionate impact of SA-CCR for ‘banking organizations with relatively small derivatives portfolios’, the agencies draw a distinction in the proposed rule between the requirements which would apply to advanced approaches banks

and non-advanced approaches banks.² Specifically, while non-advanced approaches banks would have the option to make use of either SA-CCR or the existing current exposure method (“CEM”) to measure their derivatives exposures, all advanced approaches banks would be required to apply SA-CCR irrespective of the size, scope and composition of their derivatives portfolios. This includes highly specialized custody banks, such as State Street, which have small and relatively narrow derivatives exposures: either interest rate swaps entered into to hedge long-term assets held in the investment portfolio, or short-dated FX transactions entered into to support custody client investment activities in non-US markets. We believe that the agencies policy goals can better be achieved by adopting an approach which focuses on the nature and scope of a banking organization’s derivatives trading activities rather than on their status as an advanced or non-advanced approaches bank.

Under the proposed rule, advanced approaches banks and those non-advanced approaches banks choosing to opt in would be required to implement SA-CCR by July 1, 2020, well ahead of other anticipated changes to the agencies regulatory capital rules designed to reflect the various components of the Basel III review ahead of the internationally agreed-upon conformance date of January 1, 2022.³ While we appreciate the agencies’ efforts to develop a robust, standardized alternative for the measurement of derivatives exposures, we do not support implementation of SA-CCR as currently defined, and on the timeline prescribed, in the proposed rule. This reflects three considerations which are further described below.

Impact of the Supervisory Alpha Factor

First, SA-CCR is hampered by several methodological shortcomings which must be corrected prior to its adoption in the regulatory capital framework for US banks. In our view, the most significant of these flaws is the use of a supervisory factor of 1.4 (“alpha factor”), last calibrated in 2005, to gross-up the exposure amount of each netting set otherwise calculated as the sum of the replacement cost of the derivatives transactions and potential future exposure. While this is ostensibly intended to address the possibility that SA-CCR could produce exposure amounts which are lower than those obtained using an internal model based approach, the practical outcome is a material increase in required amounts of regulatory capital for certain banking organizations without regard to the actual amount of their underlying risk exposure.

This includes highly specialized custody banks, such as State Street, which do not maintain large portfolios of derivatives transactions across a broad range of tenors and asset classes, as commonly found at other banks with extensive commercial, trading and capital markets operations. Similarly, the use of a ‘one-size fits all’ alpha factor does not properly account for the particular characteristics of the custody bank FX portfolio which is primarily intended to serve the investment needs of our custody clients rather than to take on economic risk. As

² ‘Notice of Proposed Rulemaking: Standardized Approach for Calculating the Exposure Amount of Derivative Contracts’, Board of Governors of the Federal Reserve System, Office of the Comptroller of the Currency and Federal Deposit Insurance Corporation, Federal Register - Volume 83, Number 241 (December 17, 2018), page 64662.

³ ‘Basel III: Finalizing Post-Crisis Reforms’, Basel Committee on Banking Supervision (December 2017).

such, we believe that the agencies' estimate that SA-CCR would increase the average amount of risk-weighted assets of advanced approaches banks by 5% of their total derivatives exposures does not reflect the important variations in outcomes faced by highly-specialized advanced approaches banks, such as State Street, based upon the size, nature and composition of their derivatives exposures.⁴ We have, in this respect, submitted under separate cover a confidential annex which provides a comparison of our derivatives exposures under the existing CEM and the proposed SA-CCR, which we hope will provide important context as the agencies further consider the implications of the proposed rule.

In question 3 of the preamble, the agencies invite comment on 'whether the objective of ensuring that SA-CCR produces more conservative exposure amounts than internal models methodologies is appropriate,' presumably in the context of regulatory capital rules which apply to US banks.⁵ We believe that the answer is no. This reflects the unique requirements of Section 171 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"), commonly referred to as the 'Collins Amendment', and its interplay with the design of the Basel III framework which establishes the putative objective of a standardized approach for derivatives exposures that is at least as conservative as internal model-based approaches.

More specifically, while the impact of an over-calibrated SA-CCR for the measurement of derivatives exposures for banks established in other member jurisdictions of the Basel Committee is substantially mitigated by the adoption of a Basel III standardized capital floor calibrated at 72.5% of total risk-weighted assets, this concession is unavailable to US banks which are subject under the terms of the 'Collins Amendment' to a standardized capital floor calibrated at 100%. In effect then, the US regulatory capital framework incorporates a level of conservatism due to the requirements of Section 171 of the Dodd-Frank Act not found in other member jurisdictions of the Basel Committee, which makes the use of an alpha factor in the calibration of SA-CCR unnecessary.

We therefore strongly urge the agencies to reconsider the use of the alpha factor in the calibration of SA-CCR prior to finalization of the proposed rule, either on their own or in conjunction with other members of the Basel Committee, and note that a delay in the application of SA-CCR to correspond with the application of other changes foreseen in the Basel III review supports this objective.

Need for Consistency in the Treatment of Derivatives and SFT Exposures

Second, as repeatedly emphasized in the several letters that State Street submitted to the Board as part of the development of the SCCL framework, there are important similarities between derivatives transactions and SFTs which makes it highly undesirable to adopt a revised

⁴ Notice of Proposed Rulemaking, page 64685.

⁵ Notice of Proposed Rulemaking, page 64666.

methodology for the measurement of derivatives exposures on a 'solo' basis, without a corresponding change in the methodology for the measurement of SFT exposures.⁶ This reflects the ease with which a derivatives transaction can be used to replicate the economic effect of an SFT, an option that becomes more attractive to banking organizations to the extent that the agencies adopt, even for a limited period of time, two vastly different methodologies for the measurement of the underlying exposure.

This potential shift in activity away from the SFT market is not without important financial risk. For one, a shift towards the broader use of synthetic-based alternatives to SFTs will lead to the further concentration of credit risk in the already substantially oversized global derivatives market. Moreover, a decrease in SFT activities has the potential to cause lasting damage to market liquidity. As noted by the capital markets consultancy Finadium, this is because 'every trade conducted as a swap over the physical [equivalent SFT] removes liquidity from buyers and sellers of securities, leaving wider spreads and fewer opportunities for price discovery....As more trades move away from the primary market to...OTC derivatives, the impact is magnified across both the underlying and the swaps market.'⁷

Recognizing the need for an appropriately risk sensitive standardized alternative for the measurement of SFT exposures, the Basel Committee adopted in the final Basel III review the 'revised comprehensive approach' as a replacement for the existing, haircut-based 'comprehensive approach'.⁸ This new approach recognizes netting at the level of the counterparty, correlations in the movement of market prices for securities placed on loan and collateral received, and the impact of portfolio diversification. As such, and in order to mitigate the potential for arbitrage within the US regulatory capital framework, we believe that the agencies should not proceed with the implementation of SA-CCR on a 'solo' basis as foreseen in the proposed rule. Instead, they should seek to pair adoption of SA-CCR and the 'revised comprehensive approach' for SFTs as part of their anticipated review of the regulatory capital framework for US banks designed to implement the various changes foreseen in the Basel III review ahead of the internationally agreed upon conformance date of January 1, 2022.⁹

Implications of SA-CCR for Compliance with the SCCL Final Rule

Third, the agencies proposal to require implementation of SA-CCR by July 1, 2020, overlooks the substantial compliance challenges which many banking organizations already face in meeting the requirements of the Board's SCCL final rule, which is effective January 1, 2020. This is particularly the case for highly specialized custody banks, such as State Street, which although

⁶ 'Proposed Rule – Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies, State Street Corporation (April 30, 2012) and 'Notice of Proposed Rulemaking – Single Counterparty Credit Limits for Large Banking Organizations, State Street Corporation (June 3, 2016).

⁷ 'Securities lending, Market Liquidity and Retirement Savings: the Real World Impact, Finadium (November 2015), pages 21-22.

⁸ 'Basel III: Finalizing Post-Crisis Reforms', Basel Committee on Banking Supervision (December 2017), pages 43-45.

⁹ 'Basel III: Finalizing Post-Crisis Reforms', Basel Committee on Banking Supervision (December 2017).

subject to the advanced approaches for risk-based capital, do not have extensive derivatives portfolios, and therefore do not generally rely on internal models for the measurement of their derivatives exposures. In practical terms, this means that an advanced approaches bank such as State Street, with only limited derivatives exposures, will either have to expedite its implementation of SA-CCR by six months to correspond with the requirements of the SCCL final rule, or it will have to implement SCCL using the existing CEM approach as of January 1, 2020, and then quickly transition to another methodology in only six months' time.

In either case, we believe that the cost and complexity of compliance with the agencies approach will materially increase for banks such as State Street, without any compelling benefit to safety and soundness. As such, and in response to question 2 of the preamble, we strongly recommend that the agencies not require implementation of SA-CCR by July 1, 2020, opting instead to align its implementation with the expected review of the regulatory capital framework for US banks intended to implement the various components of the Basel III review.¹⁰ Alternatively, we believe that the agencies should consider the adoption of a two-tiered implementation schedule in which highly specialized custody banks, such as State Street and other similarly situated advanced approaches banks, are permitted to delay the implementation of SA-CCR for the measurement of their derivatives exposures for a period of eighteen months (*i.e.* until January 1, 2022), in order align their SA-CCR compliance efforts with the broader set of changes to the regulatory capital rules foreseen in the Basel III review.

CONCLUSION

Thank you once again for the opportunity to comment on the important matters raised within the proposed rule. To summarize, while we recognize the agencies' efforts to develop an alternative standardized methodology for the measurement of derivatives exposures which balances simplicity and risk-sensitivity, we do not support implementation of SA-CCR as currently defined, and on the timeline prescribed in the proposed rule. This reflects three considerations: (i) the need to address pressing flaws in the SA-CCR construct, notably the use of an arbitrary and unnecessarily conservative alpha factor to gross up a firm's total derivatives exposures, ahead of its adoption in the ruleset for US banks; (ii) the importance of aligning adoption of SA-CCR for the measurement of derivatives exposures with the 'revised comprehensive approach' for the measurement of SFT exposures; and (iii) the imperative of minimizing the compliance burden of SA-CCR implementation for highly specialized custody banks, such as State Street, with limited and narrowly defined derivatives portfolios; either interest rate swaps entered into to hedge long-term assets held in the investment portfolio, or short-dated FX transactions entered into to support custody client investment activities in non-US markets.

¹⁰ Notice of Proposed Rulemaking, page 64663.

Instead, we believe that the agencies should reconsider, either on their own or in conjunction with other members of the Basel Committee, the use of an alpha factor in SA-CCR, and in the interim they should delay implementation of any final rule for US banks, so that compliance with SA-CCR is broadly aligned with other expected changes to the regulatory capital framework intended to meet the requirements of the Basel III review. This includes the use of the 'revised comprehensive approach' for the measurement of exposures to SFTs. Alternatively, the agencies may wish to consider the use of a two-tiered implementation schedule in which highly specialized custody banks, such as State Street and other similarly situated advanced approaches banks, are permitted to delay the adoption of SA-CCR for the measurement of their derivatives exposures for a period of eighteen months, or until January 1, 2022.

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

Sincerely,



Stefan M. Gavell