Meeting Between Staffs of the Federal Reserve Board, the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), and State Street Corporation
January 30, 2017

Participants: Peter Clifford, Kevin Littler, Christopher Powell, Dafina Stewart, Adam Cohen, Brian Chernoff, and Josh Strazanac (Federal Reserve Board)

James Weinberger, Ang Middleton, Ajay Palvia, David Stankiewicz, Daniel Perez, and Henry Barkhausen (OCC)

Eric Schatten, Andrew Carayiannis, Nana Ofori-Ansah, Gregory Feder, Andrew Williams, and Suzanne Dawley (FDIC)

Joe Barry, Rob McKeon, Travis Keltner, Adam Heilemann, and Paul Fleming (State Street Corporation)

Summary: Staffs of the Federal Reserve Board, OCC, and FDIC met with representatives of State Street Corporation to discuss the notice of proposed rulemaking to establish the Net Stable Funding Ratio (NSFR) in the United States. Specifically, the representatives discussed the definition of "operational deposit" in the NSFR and the Liquidity Coverage Ratio, and the available stable funding factor that would be assigned to operational deposits under the proposed rule.

Attachment

NSFR Policy Recommendations

January 30, 2017

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Overview - Custody Banks and the US Liquidity Framework

- Client deposits resulting from the provision of custody services are the primary building block of State Street's balance sheet; as of December 31, 2016, client deposits accounted for approximately 82% of our total balance sheet liabilities.

- The treatment of custody deposits in the US liquidity framework is therefore of substantial importance to State Street in the management of our day-to-day operations and in our ability to offer value-added services to our clients.

- We support robust liquidity standards and believe that the US Agencies have implemented requirements for operational deposits and liquidity stress testing ("LST") which promote the prudent management of liquidity risk.

- However, there are certain aspects of the existing and proposed US liquidity framework which have a disproportionate impact on the custody bank business model. This includes;
  - Disqualification of deposit balances which result from the provision of custody services to non-regulated funds from categorization as operational deposits;
  - Calibration of the available stable funding ("ASF") factor for operational deposits in the Net Stable Funding Ratio ("NSFR").

- These limitations can be addressed via targeted adjustments to the US liquidity framework which properly balances enhanced structural liquidity in the banking system with robust financial markets.

Operational Deposits and Non-Regulated Funds

The US Liquidity Framework does not recognize operational deposits from non-regulated funds

- Under US rules, deposit balances that result from the provision of custody and other operational services to a non-regulated fund are excluded from categorization as an operational deposit.
- This restriction is specific to the US and has been implemented alongside the exclusion in the Basel III liquidity framework for deposit balances that result from the provision of prime brokerage services.
- Non-regulated funds make use of custodian banks, such as State Street, to ensure the proper safekeeping and administration of their investment assets. The use of custodian banks by non-regulated funds has increased since the financial crisis as a way of reducing risk.
- Custody services are distinct from prime brokerage services (custodians do not facilitate or finance client trading activities) and include;
  - Access to the global settlement infrastructure in order to complete the purchase or sale of investment securities;
  - Various administrative services tied to investment assets, such as the processing of income and other interest payments, corporate action events, tax reclamations and client subscription and redemptions;
  - Access to deposit accounts in order to facilitate day-to-day transactional activities;
  - Ancillary services, such as fund administration, trustee services, investment analytics and regulatory reporting.
- Deposit balances that result from the provision of custody services to a non-regulated fund can be assessed using the same ‘operational deposit modeling processes’ used for a regulated investment fund.
- The use of a custodian bank to separate the safekeeping and administration of investment assets from a non-regulated fund’s trading and financing activities enhances financial stability, and should be encouraged by the US Agencies.

State Street's Non-Regulated Investment Fund Client Base

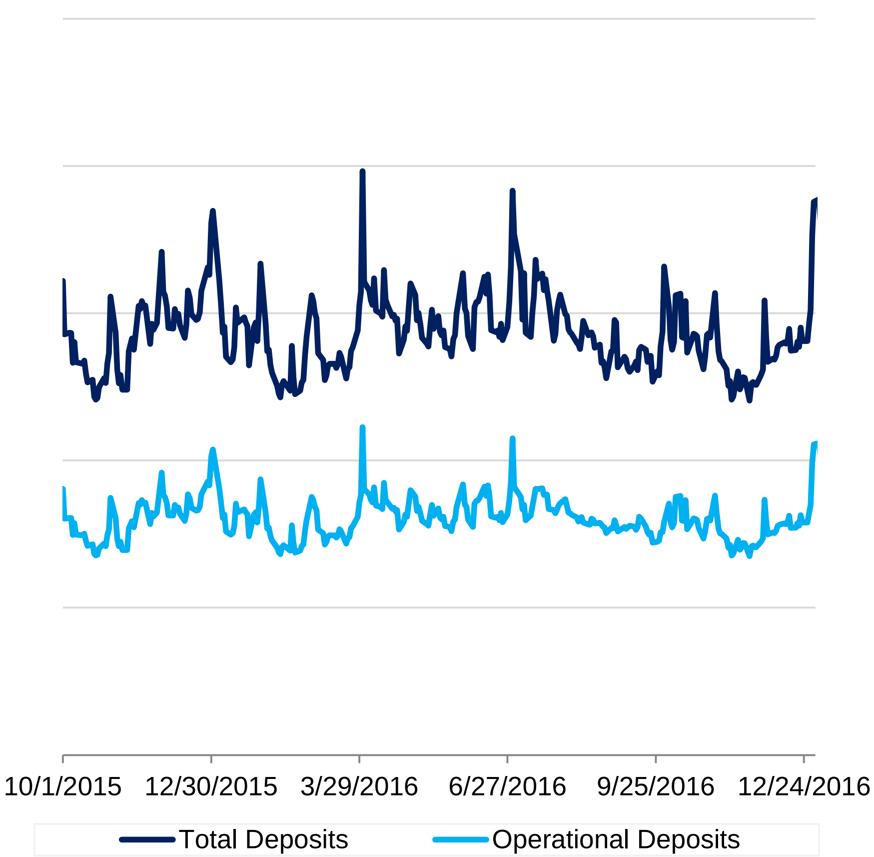
State Street's AIS deposit base is primarily driven by custody services, much like the bank's regulated fund deposit base

- State Street provides services to non-regulated funds via its Alternative Investment Services ("AIS") group; primarily private equity and hedge funds clients. The deposit characteristics of AIS clients are directly related to the services provided by State Street, as well as the fund's investment strategy.
  - As of December 30th, 2016:
    - Approximately two-thirds of AIS deposits were associated with funds utilizing State Street's **Custody Services**, in addition to other ancillary services;
    - Another sizeable amount of AIS deposits were associated with funds utilizing State Street's **Fund Administration** services, in addition to other ancillary services.
- Beyond the breadth and quality of services provided, clients have indicated that their top priorities when selecting a custodian bank are safety (i.e., the bank's credit rating and reputation) and liquidity. Clients have also indicated their preference for consolidating custody and banking services with one provider.
- In order to support day-to-day operations, including redemptions and subscriptions, capital calls and required liquidity reserves, hedge funds and private equity funds tend to hold larger cash balances relative to other custody clients.
  - Clients typically have monthly subscriptions and quarterly (or semi-annual) redemptions that require notice periods in excess of 60 days.
  - Certain non-regulated funds are required to hold a fixed portion of their NAV in cash or cash equivalents in order to meet investment requirements and to cover margined investment positions.

Potential Operational Deposit Capture for Non-Regulated Funds

AIS deposits have an operational deposit capture rate that is similar to the operational deposit capture rate for State Street's total deposit base

Figure I – Potential Non-Regulated Fund Operational Deposit Composition



The figure to the left shows a back test of the operational deposit level generated from State Street's non-regulated fund in the period from October 1st, 2015 to December 30th, 2016.

This back test demonstrates an operational deposit capture rate for our non-regulated funds that is similar to the operational deposit capture rate for our total deposit base.

In both cases, State Street's operational deposit modeling processes identifies and excludes deposit balances that do not meet the prescribed qualification requirements (i.e. 'excess amounts').

If the Agencies do not adjust the current treatment of deposits from non-regulated funds, custody banks, such as State Street, will face substantial constraints in their ability to offer custody services to non-regulated funds.

Note: Non-regulated investment fund operational deposit levels for this analysis were calculated for the sole purpose of estimating their operational deposit potential, and were computed using State Street's payments based operational deposit methodology.

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Calibration of the ASF Factor for Operational Deposits

The treatment of operational deposits in the NSFR is highly conservative

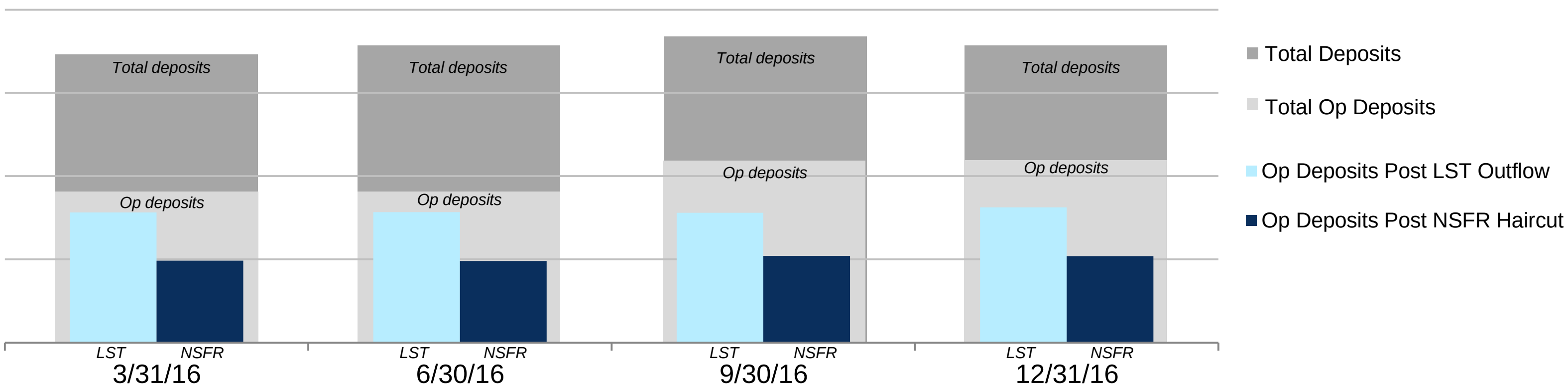
- Operational deposits face a number of requirements that do not generally apply to other types of deposit liabilities:
  - Operational deposits are limited to deposits that result from the provision of ‘clearing, custody and cash management services’;
  - Operational deposits must meet a series of stringent qualification requirements; notably a firm must demonstrate that deposits are ‘empirically linked to the (underlying) operational service’ and that there is a methodology in place to identify and exclude ‘excess amounts’;
  - Operational deposits must be identified using a data-driven ‘operational deposit modeling process’, designed to identify deposit balances which are directly linked to each client’s day-to-day transactional needs .
- Large US banks, such as State Street, are also subject to the FRB’s annual ‘comprehensive liquidity assessment and review’ (“CLAR”) process, designed to assess the sufficiency of a firm’s liquidity risk management practices. Key to the CLAR process is a detailed review of the firm’s LST framework, and its accompanying operational deposit models.
- The US Agencies have therefore implemented a framework for operational deposits that is extremely robust and which can be used to accurately gauge the presence of stable funding over both a short-term stressed (LCR) and a longer-term structural (NSFR) horizon.
- The US Agencies are now proposing to combine this highly granular, empirically-based assessment of operational deposits with a risk-insensitive ASF factor of 50%.
- This results in a measure of longer-term structural funding that is far too conservative, with outcomes that are substantially more restrictive than outcomes observed from routine LST.

Operational Deposit Impact Comparison

NSFR requirements drive more severe impacts than LST, which is based on the same one-year horizon

- The figure below compares the impacts of LST and the NSFR on State Street's operational deposits; our LST methodology classifies custody clients into discrete behavioral groups/ tiers based on the number of services provided, the criticality of those services, deposit volumes and insight from business units globally.
- While both liquidity measures use the same one-year time horizon, the NSFR is intended to reflect the stability of funding across all 'market conditions', whereas LST is based on a sustained period of financial stress.

Figure II – Operational Deposit Impact



- The NSFR's proposed 50% ASF factor produces outcomes which are significantly <u>more severe</u> than the outflow rate identified via our LST.
- If the proposed ASF factor for operational deposits is not adjusted to more closely align with the results of LST, the NSFR will likely become a binding constraint for State Street and will require further adjustments to our balance sheet that will impact our ability to accommodate client cash.

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