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January 22, 2018

Ann Misback, 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 Numbers: OP-1586, OP-1587, OP-1588

Proposed Policy Statements and Enhanced Disclosure Notice – Federal Reserve Bank Stress Testing Transparency

Dear Sir/ Madam:

State Street Corporation ("State Street") welcomes the opportunity to comment on the policy statements and the enhanced disclosure notice issued by the Board of Governors of the Federal Reserve System ("FRB") to improve the transparency of its supervisory stress testing process. This includes: (i) a proposed stress testing policy statement, (ii) the enhanced disclosure of certain models used in supervisory stress testing, and (iii) amendments to the stress testing scenario design framework. We welcome the FRB's efforts to enhance the transparency of stress testing for bank holding companies ("BHC") which are subject to the Dodd Frank Act Stress Test ("DFAST") and the Comprehensive Capital Analysis and Review ("CCAR") process, and we agree that improved transparency provides important benefits by strengthening the credibility of the stress-testing process, providing greater opportunity for public input, and ensuring the greater predictability of balance sheet outcomes. Nevertheless, we believe that the FRB's proposals are insufficiently ambitious, and that much greater levels of transparency in the DFAST and CCAR stress test process are warranted.

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 $32.11 trillion in assets under custody and administration and $2.67 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 United States BHC, with operations conducted through several entities, primarily its wholly-owned insured depositary institution subsidiary, State Street Bank and Trust Company. As a stand-alone custody bank, State Street derives a substantial amount of its revenue from fee-based income rather than from the generation of yield on credit risk assets. For instance, as of September 30, 2017, fee-based revenue comprised 78.8% of our total revenue. Similarly, State Street makes relatively few loans and we do not engage in significant trading or other capital markets activities. As of September 30, 2017, our Basel III advanced approach common equity Tier 1 ("CET1") ratio was 12.6% and our Basel III standardized approach CET1 ratio was 11.6%. Our estimated *pro forma* supplementary leverage ratio equaled 6.5% at the level of the BHC and 6.9% at the level of our primary bank subsidiary.

We have participated in the development of industry association responses to the proposed policy statements and the enhanced disclosure notice, notably the submission from The Clearing House Association, which we endorse. Our intention in submitting this letter is to emphasize a select number of issues of particular concern to State Street that result from our custody bank business model, specifically: the intended scope of the enhanced disclosure of models used in supervisory stress testing; the proposal to incorporate short-term wholesale funding costs in future stress test scenarios; and the characterization of credit supply assumptions in the proposed policy statement on supervisory stress testing.

Our perspective on each of these matters is as follows:

Enhanced Disclosure of Models in Supervisory Stress Testing

In response to feedback received from the public regarding the need for greater transparency in its supervisory stress testing process, the FRB has proposed a number of changes which focus on the models used to assess loan exposures, in particular corporate loans. This includes more detailed information on the structure of the models used by the FRB and their underlying variables, the provision of modeled loan loss rates grouped by key characteristics, and the publication of portfolios of hypothetical loans and their estimated losses.

While we agree that these changes are useful and that they will help to improve the industry's understanding of the methodologies used by the FRB to estimate loan-related exposures, we note that this information is of limited value for custody banks, such as State Street, which make relatively few loans and which derive most of their interest income from investments in diversified portfolios of investment securities. As such, we strongly urge the FRB to expand the scope of its proposed disclosure of supervisory stress testing information to provide for comparable levels of transparency across the spectrum of models used in the DFAST and CCAR

[1] As of September 30, 2017.

process. In particular, the FRB should ensure the disclosure of adequate information to permit all banks subject to supervisory stress testing to more fully understand the methodologies and assumptions used to assess their material exposures, regardless of business model. In the case of custodian banks, this includes detailed information on the structure, characteristics and variables of models used to estimate the core components of pre-provisioned net revenue ("PPNR"), such as interest income, interest expenses, non-interest income and non-interest expenses, as well as losses related to operational risk events. This also includes the underlying components of the variables used by the FRB in the modeling of securities exposures, notably the assessment of other than temporary impaired ("OTTI") items and other comprehensive income ("OCI").

Incorporating Short-Term Wholesale Funding Costs in Supervisory Stress Testing

As part of its review of the scenario design framework for supervisory stress testing, the FRB provides notice of its intention to incorporate short-term wholesale funding costs in future DFAST and CCAR stress testing. This would first be reflected in the 'adverse scenario' for 2019, before being expanded to the 'severely adverse scenario' no earlier than in 2020. The FRB acknowledges in its proposed policy statement that the inclusion of short-term wholesale funding costs in DFAST and CCAR would materially enhance the stringency of the stress testing process, with the intensity of that stringency being driven by key assumptions, such as the types of liabilities stressed, as well as the duration and magnitude of that stress. In view of the inherent complexity of incorporating measures of liquidity in the capital estimation process, we appreciate the FRB's acknowledgment of the potentially severe implications of this step. Furthermore, we urge the FRB to proceed with caution when designing any potential measure of short-term wholesale funding costs for inclusion in its supervisory stress testing, so as to target clear increases in such costs without unnecessarily capturing or disadvantaging certain industry business models.

As an example, we do not believe that it would be appropriate for the FRB to rely on the methodology used to calculate the presence of short-term wholesale funding in the Method 2 global systemically important bank ("G-SIB") capital surcharge approach in a measure of short-term wholesale funding costs under stress. This includes the use of the assumption, derived from the qualification requirements for operational deposits in the Liquidity Coverage Ratio rule, that 'excess amounts' of custody deposits represent unstable wholesale funding.[2] As emphasized in our April 2015 comment letter to the FRB on the G-SIB capital surcharge framework, this characterization fails to recognize that 'excess amounts' of custody deposits are still derived from the provision of safekeeping and asset administration services provided to clients pursuant to a legally binding written custody agreement, are held in the client's primary

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[2] 'Liquidity Coverage Ratio: Liquidity Measurement Standards Final Rule', Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation and Office of the Comptroller of the Currency, Federal Register, Volume 79, Number 197 (October 10, 2014).

cash account used for the processing of day-to-day transactional activities, and are either non-interest bearing or priced at below market rates which do not create an economic incentive for the client to leave excess funds on deposit with the custody bank.[3] Furthermore, the presence of 'excess amounts' of custody deposits is also consistent with the role played by custodian banks as a safe haven for client cash, especially in periods of financial market stress.

More broadly and in the context of our prior observation on the proper scope of the FRB's proposal to enhance the disclosure of information on its supervisory models, we note the direct link which exists between the potential incorporation of short-term wholesale funding costs in the DFAST and CCAR process and the estimation of PPNR, an outcome which further reinforces our recommendation for greater transparency across the full range of models used by the FRB when estimating a bank's capital ratios and net income under stress.

Stress Testing Policy Statement on Credit Supply Maintenance

In Section 2.7 of its proposed policy statement on supervisory stress testing, the FRB notes that while the aggregate supply of credit in the banking system should not materially contract in a period of stress, this can be evidenced in either <u>'fixed or growing'</u> bank balance sheets. Similarly, the FRB asserts that 'the assumption that a balance sheet of <u>constant or increasing magnitude</u> is maintained allows supervisors to evaluate the health of the banking sector', including the ability of banks to continue to support the demand for lending, as appropriate.

This view of the bank balance sheet under stress appears to be broadly consistent with the observation made by former Governor Daniel Tarullo in September 2016, that it may be appropriate for the FRB to replace the existing assumption of balance sheet growth in DFAST and CCAR stress testing with a 'simple assumption that balance sheets and risk-weighted assets remain <u>constant</u> over the severely adverse scenario horizon.'[4] This reflects, in turn, his view that the decline in demand for loans during a recession can plausibly be attributed to 'the impact of (a) recession, rather than to capital constraints at the largest banks.'[5] Furthermore, Governor Tarullo goes on to note that this change in the DFAST and CCAR process 'would make the treatment of balance sheet and risk-weighted assets simpler and more transparent.'[6] We strongly endorse former Governor Tarullo's recognition of the logic of a constant balance sheet for the estimation of bank capital ratios and net income under stress.

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[3] 'Notice of Proposed Rulemaking – Risk-Based Capital Guidelines: Implementation of Capital Requirements for Global Systemically Important Bank Holding Companies', State Street Comment Letter to the Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation and Office of the Comptroller of the Currency, April 2, 2015.

[4] Next Steps in the Evolution of Stress Testing', Speech by FRB Governor Daniel K. Tarullo at the Yale School of Management Leader's Forum, September 26, 2016.

[5] Speech by FRB Governor Daniel K. Tarullo, September 26, 2016.

[6] Speech by FRB Governor Daniel K. Tarullo, September 26, 2016.

As previously noted in our comment letter, custody banks such as State Street have a unique business model which focuses not on the intermediation of credit assets, but rather on the day–to-day provision of safekeeping and asset administration services to institutional investor clients. This includes unimpeded access to payment, clearing and settlement systems globally. As such, while supervisory stress testing is unquestionably an essential component of the supervisory framework for custody banks, it makes little sense for the stress testing process to incorporate assumptions based on an increase in a custody bank's lending activities. Moreover, while it is true that custody banks tend to experience rapid increases in client deposits during periods of financial market stress, due to their role as a safe haven for client cash, these deposit inflows are not used to expand balance sheet assets or to fund credit exposures. Instead, they are managed in the safest way possible through the placement of excess cash with national central banks.

As such, we welcome the FRB's recognition that it is sensible in many cases to assume that banks will maintain a constant balance sheet under stress, and we strongly urge that this assumption be promptly reflected in the DFAST and CCAR stress testing process. Indeed, without such a change, custody banks will continue to be subject to a supervisory stress testing process that does not accurately reflect their unique business model, and which may unfairly limit their ability to meet their clients' well-established operational needs.

Thank you once again for the opportunity to comment on the matters raised within the proposed policy statements and the enhanced disclosure notice. To summarize, while State Street supports the FRB's efforts to improve the transparency of the models used in supervisory stress testing, we strongly recommend that the FRB expand the scope of its proposed disclosure of modeling-related information to include the full range of supervisory models used in the DFAST and CCAR process. This includes models used to estimate exposures which are material for custodian banks, such as PPNR, OTTI and OCI. Furthermore, we urge the FRB to proceed with caution when seeking to incorporate short-term wholesale funding costs in its stress testing framework, in order to accurately capture unaccounted for changes in a bank's funding costs without unfairly targeting the custody bank business model. Finally, we welcome the FRB's acknowledgment that bank balance sheets may remain constant under stress, and we urge that this assumption be promptly incorporated within the DFAST and CCAR process.

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

Sincerely,

John J. Slyconish