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Docket ID: OCC–2013-0016

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Docket Number: R-1466

Robert E. Feldman, Executive Secretary
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Joint Notice of Proposed Rulemaking – Liquidity Coverage Ratio: Liquidity Risk Measurement, Standards and Monitoring

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"), implementing for certain banking entities in the United States ("US") a quantitative liquidity requirement, specifically the Liquidity Coverage Ratio ("US LCR"). The US LCR is designed to strengthen the short-term liquidity risk profile of banks and the resilience of the US financial system, and is intended to be broadly consistent with the international standard adopted by the Basel Committee on Banking Supervision ("Basel Committee") in the Basel III Accord ("Basel III LCR").[1] It is also designed to complement the more qualitative liquidity standards foreseen in Section 165 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"), as proposed by the FRB in December 2011.[2]

The US LCR generally applies to bank holding companies ("BHC"), savings and loan holding companies ("SLHC") and insured depository institutions ("IDI") with more than $250 billion in total consolidated assets or $10 billion in foreign exposures, as well as non-bank financial companies designated by the Financial Stability Oversight Council for FRB supervision, that do not engage in substantial insurance activities (collectively "covered banks" or "covered companies"). In addition, the federal banking agencies have proposed the introduction of a modified LCR for BHCs and SLHCs without substantial insurance activities, which have total consolidated assets of more than $50 billion. The US LCR is intended to be effective as of January 1, 2015, with a phased implementation schedule extending to January 1, 2017, or two years ahead of the Basel III LCR.

Headquartered in Boston, Massachusetts, State Street specializes in providing institutional investors with investment servicing, investment management and investment research and trading. With $27.43 trillion in assets under custody and administration and $2.35 trillion in assets under management, State Street operates in 29 countries and in more than 100 geographic markets.[3] 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.

Our perspective in respect of the joint NPR is informed by our status as one of the world's largest providers of global custody services. As a custody bank, we specialize in serving the investment needs of institutional investor clients, and maintain 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 day-to-day management of investment assets. These clients include asset owners, asset managers, and official institutions, and encompass US mutual funds ("'40 Act Funds") and other similar foreign equivalents; alternative investment funds; corporate and public retirement plans; sovereign wealth funds; insurance company general and separate accounts; charitable foundations and endowments.

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[1] Basel Committee on Banking Supervision, "Basel III: The Liquidity Coverage Ratio and Liquidity Risk Monitoring Tools" (January 2013).
[2] Board of Governors of the Federal Reserve System' "Enhanced Prudential Requirements and Early Remediation Requirements for Covered Companies" (December 2011).
[3] As of December 31, 2013.

We appreciate the opportunity to offer insight relative to the impact of the joint NPR 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. Our conservative business model and deposit funded balance sheet result in a robust structural liquidity position, with high-levels of resilience to both idiosyncratic and general financial market stress.

INTRODUCTORY COMMENTS

State Street welcomes the efforts of the federal banking agencies to strengthen the liquidity profile of covered banks and the overall stability of the US financial system. This includes the establishment of appropriate liquidity risk management standards and the introduction of a quantitative liquidity requirement. We have been actively engaged in the development of liquidity regulation since the proposed Basel III Accord in late 2009. This includes an April 2010 comment letter to the Basel Committee, where we emphasized the importance of developing a liquidity framework that recognizes the particular business model of custody banks. In addition, we note our April 2012 comment letter to the FRB in response to proposed rulemaking on enhanced prudential standards for certain US banking entities, where we emphasized our support for the comprehensive management of liquidity risk, and the maintenance by financial institutions of an appropriately defined buffer of high-quality, highly-liquid assets.

In order, however, to avoid unintended outcomes, notably constraints on the flow of liquidity within financial markets and the misrepresentation of liquidity risk, we believe that the US LCR must be carefully calibrated and must endeavor to provide an accurate assessment of the liquidity profile of covered companies. This includes a data driven assessment of inflow and outflow assumptions used in the LCR, informed by industry experience during the financial crisis. The federal banking agencies should also undertake a careful assessment of the cumulative impact of various components of the proposed rulemaking, such as prescribed haircuts and funding caps on eligible high-quality liquid assets (“HQLA”), outflow and inflow assumptions, and calculation methodologies which in the aggregate may result in an LCR that is unduly conservative. As an example, operational deposits derived from inherently stable custody activities are subject, under the joint NPR, to stringent qualification requirements, a conservative 25% run-off rate, the deduction of broadly defined ‘excess’ deposits and overall calculation on a ‘peak day’ outflow basis.

Moreover, we also believe that the LCR must endeavor to recognize the particular characteristics and funding profiles of varying business models. This includes the business model of custody banks, which is uniquely focused on serving the investment needs of institutional investor clients. As further described in the section on the ‘Treatment of Operational Deposits’, the custody business model centers on the provision of safekeeping and asset administration services to portfolios of investment assets. These portfolios are managed on a fund specific basis, and have significant day-to-day operational needs which require access to deposit accounts and cash management services typically performed by banks.

In certain cases, the use of banks is a function of the prevailing regulatory regime, such as the requirements which apply to both US mutual 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, such as broker-dealers. In other cases, this reflects well-established client preference to hold and manage investment portfolios with banking entities which are subject to stringent prudential requirements and regulatory oversight. Custody banks therefore have a highly focused business model, with most activities conducted within one or more bank subsidiaries.

Custody banks, such as State Street, have balance sheets that are constructed differently than most covered banks with extensive commercial and investment banking operations. Custody bank balance sheets are built around client deposits derived from the provision of core safekeeping and asset 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 most other covered banks, custody banks make few loans and do not engage in the loan securitization process. They also do not engage in significant trading or other capital markets activities.

Furthermore, we believe that it is important to bear in mind that quantitative liquidity requirements are a relatively new aspect of prudential regulation, and that it may therefore be advisable to take an incremental approach to the US LCR, in which measures are refined as further experience is gathered. Similarly, we believe that it is important to avoid the introduction of an approach that is overly prescriptive and that may result in unnecessary operational complexity. This includes, among others, the prescribed methodology for calculating total net cash outflows, requirements relative to the measurement and transferability of liquidity among consolidated entities, the calculation of both adjusted and unadjusted HQLA, and restrictions that may encourage the *de facto* 'subsidiarization' of liquidity. Indeed, we caution that although well-intended, the compliance burdens of various proposed requirements in the US LCR may at times outweigh the potential benefits, and that there may be instances in which a streamlined approach is more suitable.

Finally, we believe that it is important for the federal banking agencies to endeavor to maintain a level-playing field among internationally active banks and to avoid the introduction of an approach that broadly diverges from the international Basel Committee standard. As currently drafted, the US LCR incorporates several provisions that substantially deviate from the Basel III LCR. This includes a narrowing of the scope of eligible HQLA, broad changes in the definition of operational deposits, calculation of the LCR on a 'peak day' outflow basis, and an accelerated implementation schedule. While differences in US rulemaking may at times be warranted, it is important to recognize the competitive disparities which can ensue, along with significant additional operational complexity. This reflects the need to abide by differing LCR requirements and calculation methodologies in the various national jurisdictions in which internationally active banks, such as State Street, routinely operate.

As such, we have pressing concerns relative to several aspects of the federal banking agencies' intended approach. Specifically, we believe that the proposed rule incorporates an overly stringent approach to the treatment of operational deposits, including the definition of prime brokerage services, which results in the omission of broad swaths of custody deposits stemming from the provision of safekeeping and asset administration services to traditional investment funds, such as '40 Act Funds and their foreign equivalents. We also believe that the use of a 'peak day' outflow approach in the measurement of total net cash outflows is unduly punitive for banks, such as custody banks, with substantial amounts of indeterminate maturity deposits, and results in the *de facto* conversion of a 30-day stress metric into a one-day stress metric. Furthermore, we believe that the US LCR would benefit from the more granular treatment of certain committed lines of funding, notably those provided by custody banks to '40 Act Funds and their foreign equivalents. Nevertheless, we believe that the US LCR can be improved via a limited number of targeted adjustments, without undermining the central policy objectives of the intended rule, namely improving the liquidity profile of banks and the stability of the US financial system.

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

- Rationalization of the requirements applicable to operational deposits, including the definition of operational services;
- Introduction of a revised approach for the exclusion of prime brokerage services from operational deposits based on a specific definition of such services rather than on the exclusion of broad customer types;
- Calculation of indeterminate maturity deposit outflows and financial commitments on a straight line basis over the prescribed 30-day LCR stress horizon, or alternatively the development of a revised methodology, as an international standard;
- Recalibration of the draw-down rate for committed lines of funding to '40 Act Funds and their foreign equivalents to more closely reflect industry experience during the financial crisis.

We have participated in the development of the detailed responses submitted by various financial services trade groups, and we generally support the observations and recommendations made therein. This includes the joint letter from the American Bankers Association, The Clearing House Association, the Securities Industry and Financial Markets Association ("SIFMA"), the Financial Services Roundtable, the Institute of International Bankers and the Structured Finance Industry Group, which comprehensively identifies and addresses areas of broad industry concern. This also includes a separate letter from SIFMA's Municipal Securities Division, which focuses on the particular impact of the joint NPR on the US municipal securities market.

Our intention with this letter is to highlight issues of particular concern to State Street resulting from our custody bank business model.

TREATMENT OF OPERATIONAL DEPOSITS

Definition and Requirements for Operational Deposits

The joint NPR incorporates a definition of the term 'operational deposit', as well as a series of requirements that must be met in order for such deposits to qualify for the prescribed 25% run-off factor. While we acknowledge the federal banking agencies desire to ensure that the favorable treatment afforded to operational deposits is properly limited to deposits which are truly operational in nature, we believe that certain adjustments are required in order to more precisely reflect the characteristics of custody deposits and the custody bank business model generally.

As an initial matter, we recommend clarification that covered banks provide operational services in various capacities, and that these services are not limited to instances where the bank is acting as 'an independent third-party intermediary'. As an example, covered banks routinely act as a directed trustee for pension funds regulated under the US Employee Retirement Income Security Act and their foreign equivalents. They also act as trustee for, among others, Irish and United Kingdom Unit Trusts, and serve as fund administrator on behalf of numerous investment fund structures globally. As a result, the definition of 'operational deposit' in subpart A 3 of the proposed rule should be expanded to incorporate instances where a covered bank is providing operational services as 'agent or administrator'.

Furthermore, we believe that the use of terms such as 'required' or 'critically important' when describing the scope of operational deposits is unnecessarily stringent, and that a better alternative is to emphasize the fact that deposit balances are a necessary by-product of operational services offered by covered companies. More specifically, we recommend redrafting the opening portion of the definition of 'operational deposit' as follows: *"Operational deposit means unsecured wholesale funding that is <u>necessary</u> for the [BANK] to provide operational services…".*

Paragraph 94 of the Basel III LCR specifies that in order for an operational deposit to qualify for the 25% run-off factor, the underlying 'operational service' must be provided by a bank pursuant to a legally binding written agreement, with termination periods extending beyond 30 days, or with substantial termination costs to be borne by the client. This includes costs associated with various operational, information technology and legal matters. In comparison, the joint NPR ties the prescribed legally binding written agreement and associated termination provisions to 'operational deposits'.

We believe that it is important to note that custody relationships are structured on the basis of asset servicing contracts rather than more limited client deposit agreements. This reflects the role played by custody banks in the safekeeping and administration of investment assets, core operational functions that require access to deposit accounts and that result in the accumulation of frictional cash, otherwise known as custody deposits. Indeed, the primary factor driving the stability of custody deposits as a source of funding is the direct link between the custody deposit and the underlying operational services rendered.

As prescribed by the Basel Committee, safekeeping and asset administration services are provided by custody banks pursuant to a legally binding written agreement, with minimum notification periods that can extend for 60 or more days. These agreements cover a series of investment funds, most with a separate legal identity and/or existence. Even after notification of termination, there are a number of operational considerations that must be addressed prior to the outright transfer of the assets held on behalf of individual funds. This includes the establishment of client profiles on relevant custody and accounting systems, the migration of accounting and other financial data, the initiation of a parallel period of shadow accounting and the notification of revisions to settlement instructions for each of the global markets in which the client transacts. It is therefore not uncommon to have transitional periods in the custody industry of anywhere between six to twelve months, with the prospect of even lengthier timeframes should multiple clients seek to leave a custodian entity at the same time.

Most importantly, clients are unlikely to materially reduce their custody deposits during the transition period since these deposits are necessary to support ongoing, day-to-day investment activities within individual funds. Although certain clients may have a business relationship with several custody banks, this generally centers on the use of different service providers for different lines of business or varying asset classes, due to particular areas of custody expertise and/or pricing considerations. The use of several custody banks does not, however, extend to individual funds which, in our experience, are always serviced by one custody provider. We note, in this respect, that State Street currently offers safekeeping and asset administration services to in excess of 50,000 individual funds, across varying client types, asset classes and legal structures.

In certain cases, the use of a single custody provider is a reflection of legal and/or regulatory considerations. As an example, the EU UCITS V Directive requires the appointment of a single depositary for each investment fund, with an extensive range of prescribed safekeeping, cash management and oversight functions.[4] This is also true of funds managed by entities subject to the requirements of the EU Alternative Investment Fund Managers Directive.[5] In addition, the use of a single custody provider also reflects a number of practical considerations, such as limitations on the ability of institutional investors to pool or otherwise commingle securities that belong to different fund structures and/or legal entities, the desire to maintain centralized oversight and control over day-to-day investment activities, and the desire to limit expenses that may serve as a measurable drag on fund performance.

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[4] European Commission, "Proposal for a Directive of the European Parliament and of the Council Amending Directive 2009/65/EC on the Coordination of Laws, Regulations and Administrative Provisions Relating to UCITS as Regards the Depositary Function, Remuneration Policies and Sanctions" (July 3, 2012), Article 22.

[5] European Commission, "Directive of the European Parliament and of the Council on Alternative Investment Fund Managers" (June 8, 2011), Article 21.

We therefore recommend that the federal banking agencies amend subpart A 4(b)(1) of the proposed rule by replacing the term <u>operational deposit</u> with the term <u>operational service</u>. We also suggest removal of the reference to the withdrawal of operational deposits prior to the end of the notice period since this is inconsistent with the underlying purpose and use of such deposits. Specifically, this would involve the re-drafting of subpart A 4(b)(1) as follows: *"The operational service must be offered pursuant to a legally binding written agreement, the termination of which is subject to a minimum 30-day notice period or significant switching costs borne by the customer"*.

Furthermore, we are confused by the requirements specified in subpart A 4(b)(2) of the rule, relative to 'volatility in the average balance of the deposit', since this seems to duplicate the requirement of subpart A 4(b)(6) that covered banks identify and exclude excess deposits from operational deposit amounts. Moreover, it is unclear to us how the concept of 'significant volatility' can be reconciled with the concept of an average deposit balance. We therefore recommend the deletion of the requirement specified in subpart A 4(b)(2) of the proposed rule. In its place, we suggest the introduction of the requirement found in the Basel III LCR that *"The deposit must be a by-product of the underlying services provided by the [BANK] and not sought out in the wholesale market, in the sole interest of offering interest income"*.[6]

Definition of Operational Services

The joint-NPR incorporates a prescriptive definition of operational services based upon an itemized inventory of services performed as part of clearing, custody and cash management activities. While we acknowledge the concerns that may exist relative to the mis-categorization of varying financial activities as operational services, we believe that this approach introduces additional complexity, and that it may also result in the omission of certain operational services clearly intended to fall within the scope of the rule. This includes a number of services offered by custody banks in the normal course of providing safekeeping and fund administration services to institutional investor clients.

One of the primary reasons for the introduction of a 25% run-off rate for certain wholesale deposits in the Basel II LCR was to recognize the liquidity value intrinsic in custody deposits. The decision to incorporate custody deposits within a more general category of operational deposits has tended to dilute the value of such deposits, and opened the door to broader categories of deposits where the operational ties are potentially less significant. Consequently, we recommend several adjustments to the definition of operational services designed to more clearly reflect the functions performed by custody banks.

First, we recommend the incorporation of a new sub-category of operational services; specifically the 'administration of investment assets'. This is designed to capture the broad range of activities performed by custody banks in the normal course of business not currently

[6] Basel Committee on Banking Supervision, "Basel III: The Liquidity Coverage Ratio and Liquidity Risk Monitoring Tools" (January 2013), paragraph 95.

specified in the proposed rule, including the receipt of dividend and other investment income, the processing of corporate action events and tax reclamations. Second, and in recognition of the growing importance of custody banks in the management of collateral assets, including in the rapidly evolving over-the-counter ("OTC") derivatives market, we recommend the introduction of a further sub-category of operational services, namely 'collateral management services'. This would encompass the safekeeping and administration of cash and non-cash collateral, as well as the processing of initial and variation margin. This would also include access to financial market infrastructure, notably central clearinghouses and trade repositories. Finally, we recommend that the scope of services specified in sub-category 6 of the definition be expanded to include the settlement of foreign exchange transactions, which is a direct and necessary by-product of investment activities in global financial markets.

Definition of Prime Brokerage Services

Consistent with the international Basel Committee standard, the federal banking agencies exclude two categories of financial activities from the scope of operational deposits: correspondent banking and the provision of prime brokerage services.[7] In the case of correspondent banking, the federal banking agencies have adopted an approach based on a description of the correspondent banking function, namely deposits owned by another bank as respondent and temporarily placed in an overnight deposit with another bank as correspondent. In the case of prime brokerage services, however, the federal banking agencies have taken a very different approach, focusing on broad categories of customer types that may at least in theory make use of prime brokerage services. Specifically, the federal banking agencies propose to address prime brokerage services by excluding all deposits "provided in connection with….operational services (rendered) to an investment company, non-regulated fund or investment adviser".

We believe that this approach is severely flawed since it captures broad swaths of deposits that result from the provision, by custody banks, of core safekeeping and asset administration services to traditional investment funds, wholly unrelated to prime brokerage. Operational deposits are an essential component of the custody bank business model, which is uniquely focused on serving the investment needs of institutional investor clients. These clients contract with custody banks to ensure the proper safekeeping of their investment assets across various investment funds, as well as the provision of a broad range of related 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 operational needs. Indeed, the strong operational dependencies of the custody bank business model is one of the primary factors that led the Basel Committee to

[7] Basel III: The Liquidity Coverage Ratio and Liquidity Risk Monitoring Tools', Basel Committee on Banking Supervision (January 2013), paragraph 99.

incorporate within the Basel III LCR a specific outflow category for operational deposits as distinct from wholesale funding generally.

Since custody banks maintain the primary operational accounts of institutional investor clients, they are the recipients of substantial day-to-day transactional deposit flows. They also hold balances associated with the prudent management of investment assets. These balances are established by clients to address anticipated and unanticipated funding needs stemming from various operational considerations. This includes failed securities transactions, the non-receipt of payments, timing differences in the movement of cash, and client redemption activities, and will vary according to the investment profile of the fund. As an example, equity portfolios typically have higher balances due to the need to manage settlement cycles that can extend over a period of three or more business days. This is also true of emerging market portfolios which must account for timing considerations in the execution of foreign currency transactions across numerous global markets. As such, custody banks and their clients view these balances as an integral component of each investment fund, and therefore as an important element in overall operational deposit flows.

More generally, given their crucial role in supporting normal course investment activities, custody deposits cannot be systematically removed from the custody bank without the risk of significant disruption to essential payment, clearing and settlement functions. This is true regardless of whether the custody provider is facing a period of idiosyncratic or financial market stress. As an example, insufficient client deposit balances have the potential to disrupt the timely settlement of securities transactions, the movement of funds through the FedWire and other similar payment systems, and the provision of cash margin in support of OTC derivatives transactions. Insufficient funding could also disrupt the routine processing of client subscriptions and redemptions, including on behalf of ’40 Act Funds and their foreign equivalents, structured for sale to the retail investor community.

There is substantial empirical evidence that a signification proportion of the deposits held by custody banks are stable over a multi-year horizon and therefore represent core deposit funding. This can be seen, among others, in an assessment of the close relationship that exists between total assets under custody and operational deposits, as defined in the joint NPR. State Street has submitted the results of this assessment to the federal banking agencies via a separate confidential annex. We are happy to review the details of this confidential submission with the federal banking agencies as may be helpful.

Concurrently, we reiterate that custody deposits are a by-product of safekeeping and asset administration services, and are required to meet the operational needs of our clients. We also note that custody deposits are priced well below prevailing market rates and are therefore not designed as a means of obtaining alternative, non-core funding. As such, custody deposits are fundamentally different in their nature and liquidity profile than deposits derived from the provision of prime brokerage and other similar services.

There are several important considerations that differentiate the custody bank business model from the prime broker business model. Unlike the prime broker business model, the custody of assets stands at the very center of the custody banking relationship, which is uniquely focused on safeguarding the investment assets of institutional investor clients. These assets are held in specifically designated client accounts and are subject to full segregation from the custody bank's own assets. In contrast, the custody of assets is incidental to the prime broker business model, which centers on two interrelated functions.

The first is facilitation of client trading activity. This involves the assumption, by the prime broker, of responsibility for clearing, settling and carrying transactions entered into by the client with one or more third party entities, generally referred to as an 'executing broker'. This function is described in a letter from the US Securities and Exchange Commission dated January 25, 1994 (the "SEC letter"), which provided the industry with the necessary exemptive relief to permit the establishment of prime brokerage arrangements. Specifically, the SEC letter states that *"Prime brokerage is a system developed by full service (broker-dealer) firms to facilitate the clearance and settlement of securities trades….Prime brokerage involves three distinct parties: the prime broker, the executing broker and the customer. The prime broker is a registered broker-dealer that clears and finances customer trades executed by one or more other registered broker-dealer ('executing broker') at the behest of the customer. Each of the executing brokers receives a letter from the prime broker agreeing to clear and carry each trade placed by the customer with the executing broker."*[8] Similarly, the FRB noted in a January 16, 1998 rule release that *"Prime brokerage is an arrangement involving a customer and at least two broker-dealers, one of whom is the 'prime broker'. Transactions on behalf of the customer are effected by the non-prime broker (known as the 'executing dealer') and are immediately sent to the prime broker… wherever executed".*[9]

The second core function of the prime broker is the provision of financing to facilitate the execution of the client's investment strategies. This role is emphasized by the United Kingdom's Financial Conduct Authority, which notes in its official Handbook that prime brokers provide *'financing, the provision of which includes one or more of the following: capital introduction, margin financing, stock lending, stock borrowing and entering into repurchase or reverse repurchase transactions".*[10] As a direct consequence of this role, prime brokerage agreements authorize the prime broker to make use of client assets in the extension of funding, also known as asset 're-hypothecation'. This is emphasized, among others, in an April 2012 report from the Financial Stability Board which states that *"(a) prime brokerage agreement is based on a pledge over the hedge fund's total in-custody assets…Hedge funds are able to borrow cash or securities up to this value less a margin….Prime brokerage agreements usually give the prime broker the*

[8] Division of Market Regulation, United States Securities and Exchange Commission, Letter Addressed to Mr. Jeffery C. Bernstein of the Prime Broker Committee – Securities Industry Association (January 25, 1994).
[9] Board of Governors of the Federal Reserve, "Securities Credit Transactions: Borrowing by Broker-Dealers" (Final Rule) (January 16, 1998).
[10] Financial Conduct Authority – United Kingdom, "FCA Handbook", Glossary - Release 137 (May 2013).

right to re-use the pledged assets it holds on behalf of the hedge fund, up to a proportion of its net indebtedness".[11]

Neither of these two prime broker functions apply in the context of the custody bank business model. This underlines, in turn, the crucial importance of an approach in the joint NPR that clearly distinguishes excluded prime brokerage activities from qualifying operational activities, notably custody activities.

While custody banks offer safekeeping and asset administration services to a wide range of institutional investor clients, one of the most significant are investment funds organized pursuant to the Investment Company Act of 1940, also commonly known as '40 Act Funds. These funds are an essential feature of the US financial landscape, offering retail and professional investors safe and cost effective access to retirement, savings and other wealth accumulation vehicles. As such, they are subject to stringent regulation. This includes the affirmative requirement to ensure the proper safekeeping and segregation of assets held on behalf of the underlying fund beneficiaries. This is prescribed by Rule 17f-2 of the Investment Company Act, which specifies, among other, that *"all such securities and similar investments (of the fund) shall be deposited in the safekeeping of, or in a vault or other depository maintained by a bank....Investments so deposited shall be physically segregated at all times from those of any other person"*.[12]

In practice, therefore, these requirements make it exceptionally difficult for a '40 Act Fund to enter into a prime brokerage or other similar arrangement, since as previously noted, one of the core requirements of the prime broker business model is the ability of the broker-dealer to access and make use of client assets in the extension of funding. It is useful to note, in this respect, that even in the case of a securities transaction requiring the exchange of collateral with a broker-dealer, it is industry practice to hold such collateral with the '40 Act Fund's custodian, rather than to transfer the assets to the control of the broker-dealer or other related third-party entity.

In order to ensure a more balanced and proportionate regulatory outcome, we therefore strongly recommend that the federal banking agencies adopt a different approach for the exclusion of prime brokerage services from the scope of operational deposits. Specifically, we recommend that subpart A 4(b)(7) of the proposed rule be amended by replacing the reference to broad customer types that may at least in theory enter into a prime brokerage agreement, with an explicit definition of prime brokerage services based on key business functions. As an example, the federal banking agencies may wish to specify as follows: *"The deposit must not be provided in connection with the [BANK's] provision of prime brokerage services, defined as a package of services offered by a [Bank] under a contractual arrangement whereby the [Bank], among other services, clears, settles, carries and finances transactions entered into by the client*

[11] Financial Stability Board, "Securities Lending and Repos: Market Overview and Financial Stability Issues" (Interim Report) (April 27, 2012).
[12] 15 U.S.C. 80a-17(f).

with the [BANK] or a third-party entity (such as an executing broker), and where the [BANK] has a right to use assets provided by the client, including in connection with the extension of margin and other similar financing of the client, subject to applicable law.

Alternatively, the federal banking agencies may wish to revise subpart A 4(b)(7) of the proposed rule so that it more clearly focuses on customer types that are most likely to make use of excluded prime brokerage services, namely hedge funds and other similar private funds. This can be achieved by removing the reference to 'investment company' in the proposed rule, as well as adjusting the general reference to 'investment adviser' as follows: *"The deposit may not be provided in connection with the [BANK's] provision of operational services to a non-regulated fund or investment adviser when managing the assets of a non-regulated fund".*

While this solution does not fully address the limitations inherent in an approach to the definition of prime brokerage services based upon general customer types, it at least serves to address its most obvious and compelling limitations. This is especially true of the removal of the reference to investment companies, which as previously noted, are exceptionally unlikely, due to regulatory requirements and commercial expectations, to enter into a prime brokerage agreement.

'PEAK DAY' OUTFLOW CALCULATION

The Basel III LCR defines the relative liquidity profile of a covered company on the basis of two key metrics. The first is the value of HQLA held which can be readily converted into cash or otherwise used to support a firm's liquidity needs during a period of acute short term idiosyncratic or financial market stress (*i.e.* the LCR numerator). The second is total net cash outflows, or the expected net liquidity position of a firm calculated in accordance with a series assumptions prescribed by the Basel Committee for various exposure types (*i.e.* the LCR denominator). Under the international Basel Committee standard, the LCR denominator represents total net cash outflows over the course of the full 30-day stress horizon. In contrast, the federal banking agencies propose to define total net cash outflows as the highest recorded net cash outflow on any single day over the course of the LCR horizon. This 'peak day' outflow approach is intended to address possible funding mismatches within the LCR that may lead to unanticipated liquidity risk.

While we recognize the concerns of the federal banking agencies relative to mismatched funding, we note that this approach substantially deviates from the design of the Basel III LCR which is specifically calibrated on the basis of a 30-day stress event. This includes the already conservative 25% run-off rate assigned to operational deposits. Moreover, we believe that this approach is sub-optimal since it presumes the immediate 'day one' realization of all indeterminate maturity deposit outflows and financial commitments. As such, it is unduly punitive to banks, such as custody banks, that are not significantly reliant on term wholesale funding. Indeed, the federal banking agencies' approach effectively converts a 30-day stress metric into a one-day stress metric, in a manner broadly inconsistent with the international

Basel Committee standard. This also results in a *de facto* requirement to hold HQLA on a gross outflow basis, rather than on a more proportionate net outflow basis.

In order to address these limitations, we recommend clarification in the final rule that indeterminate maturity deposit outflows and financial commitments are subject to calculation by covered companies on a straight line basis over the course of the full 30-day stress horizon. This is consistent with the approach adopted by the federal banking agencies when calibrating the modified LCR to the intended 21-day standard. If the federal banking agencies nonetheless believe that an alternative methodology is warranted, we strongly recommend that this be developed as an international standard in conjunction with other members of the Basel Committee.

Moreover, in order to properly inform this process, we recommend the initiation of a study designed to develop an empirically-based understanding of possible maturity mismatches within the LCR's 30-day stress horizon that may pose risks not otherwise addressed by existing prudential regulation. This includes a careful analysis of maturity behaviors during periods of financial market stress. Without this information, we believe that it is impossible to accurately judge whether the assumptions, incremental data requirements and reporting burdens of the proposed 'peak day' outflow approach are warranted by the risk that implementation of a revised approach would address.

COMMITTED LINES OF FUNDING

Since the release of the original Basel III Accord in late 2009, the Basel Committee has taken significant steps to improve the risk-sensitivity of outflow rates for committed lines of funding provided by banks to both financial and non-financial counterparties. This includes a recalibration of outflow assumptions for committed liquidity facilities provided to public sector entities (from 100% to 30%) and committed credit facilities provided to, among others, '40 Act Funds and their foreign equivalents (from 100% to 40%).[13] While we welcome these efforts as a meaningful step forward in improving the measurement of liquidity risk in committed lines of funding, we continue to believe that further refinements of LCR outflow rates are warranted.

In general terms, we support the use of three metrics in defining outflow rates for committed lines of funding. The first is an assessment of the purpose and form of the underlying commitment. This includes a distinction between credit and liquidity facilities, as well as between working and non-working lines of credit. The second is a review of prevailing contractual terms and applicable regulatory prescriptions, with the goal of identifying factors which are likely to limit the possibility of a substantial and/or rapid draw on available funding. The third is calibration of the commitment on the basis of actual historical experience during periods of financial market stress. This is designed to ensure proper differentiation among

[13] Basel Committee on Banking Supervision, "Basel III: The Liquidity Coverage Ratio and Liquidity Risk Monitoring Tools" (January 2013), paragraph 131.

general categories of commitments, thereby avoiding the use of uniform outflow rates which may lead to unwarranted disruptions in the ability of banks to offer certain beneficial financial services. With these considerations in mind, we strongly urge the federal banking agencies to reduce the outflow rates assigned to committed lines of funding provided to ’40 Act Funds and their foreign equivalents.

As previously noted, ’40 Act Funds and their foreign equivalents play an important role in providing investors with safe and cost effective access to a wide range of retirement, savings and other wealth accumulation options. They are specifically designed for sale to the retail investor community and are subject to ongoing and detailed regulatory scrutiny. Moreover, they must adhere to stringent transparency, asset quality and diversification requirements. This includes specific limits on borrowed funds. As an example, ’40 Act Funds are not permitted to incur indebtedness unless the fund maintains an asset coverage ratio, including borrowed funds, of at least 300%. Similarly, retail UCITS are prohibited from borrowing more than 10% of the value of the fund’s net assets. For other types of UCITS, limits are set by the fund’s investment profile, but generally do not exceed 25% to 40%. ’40 Act Funds and their foreign equivalents therefore have limited and well-defined credit needs.

Custody banks provide committed facilities to ’40 Act Funds and their foreign equivalents on contractual terms to accommodate routine day-to-day operational matters that would otherwise require the accumulation of additional balances. This includes unanticipated movements of cash, client redemption activities and the payment of management fees and other expenses. Committed facilities to ’40 Act Funds and their foreign equivalents are therefore important for the smooth operation of financial markets. Moreover, they function in a manner that is similar to corporate lines of funding, rather than to general funding provided to a financial entity.

Committed facilities to ’40 Act Funds and their foreign equivalents have features that carefully limit their tenor and usage, including asset quality and diversification minimums and short repayment obligations (typically 30-60 days). Also, committed facilities to ’40 Act Funds and their foreign equivalents are either secured by the fund’s assets or are otherwise subject to de facto collateralization via a lien or other similar legal arrangement. As such, State Street’s experience is that committed facilities provided to ’40 Act Funds and their foreign equivalents represent limited credit risk and are unlikely to experience significant draw-downs, even during periods of financial market stress. This is reflected in an assessment of ’40 Act Fund utilization rates at State Street during the financial crisis, which revealed incremental drawn-down rates substantially below 10%.

We therefore urge the federal banking agencies to adjust their approach to committed lines of funding by re-classifying facilities provided to ’40 Act Funds and their foreign equivalents within the outflow category prescribed for, among others, credit facilities to non-financial corporates. More specifically, this would involve a reduction in the draw down rate for ’40 Act Funds and their foreign equivalents from 40% to 10% of the undrawn portion of the commitment.

CONCLUSION

Thank you once again for the opportunity to comment on the matters raised in the joint NPR. To summarize, while we support the introduction of a quantitative liquidity requirement for covered companies, we believe that it is important for the US LCR to be carefully calibrated on the basis of historical experience and to endeavor to reflect the particular characteristics and funding profiles of varying business models. This includes the business model of custody banks which is uniquely focused on serving the investment needs of institutional investor clients. We also believe that it is important to ensure the proper alignment of the US LCR with the internationally-agreed upon Basel Committee standard, and to avoid the introduction of requirements that may lead to unnecessary operational complexity.

We therefore recommend several targeted adjustments to the proposed rule, designed to better reflect the business model of custody banks and to more clearly focus regulatory attention on sources of market-based wholesale funding with higher levels of liquidity risk. This includes certain adjustments to the proposed definition of operational deposits, clarification regarding prescribed requirements for such operational deposits, and a broadening of the scope of activities falling within the definition of operational services. This also includes a revised approach to the exclusion of prime brokerage services from the scope of operational deposits, based on a specific definition of prime brokerage services rather than on broad categories of client types. Furthermore, we recommend calculation of indeterminate maturity deposit outflows and financial commitments in the US LCR on a straight line basis over the prescribed 30-day horizon, or the development of an alternative methodology as an international standard. Finally, we suggest the re-categorization of committed lines of funding to '40 Act Funds and their foreign equivalents as corporate lines of funding.

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