BNY MELLON Northern Trust STATE STREET

April 30, 2012

Via email: regs.comments@federalreserve.gov

Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

Re: Proposed Rule -- Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies (Docket No. 1438 and RIN 7100–AD–86)

Dear Ms. Johnson:

The Bank of New York Mellon Corporation, Northern Trust Corporation, and State Street Corporation (collectively, the "**Custody Banks**") are pleased to have the opportunity to provide comments to the Board of Governors of the Federal Reserve System (the "**Board**"), with respect the Board's notice of proposed rulemaking (the "**Proposed Rule**") implementing the enhanced prudential standards required by Section 165 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("**Dodd-Frank Act**").

The provision of custodial and trustee services to our institutional clients is a significant component of each of the Custody Banks' businesses. Collectively, we service over $50 trillion of assets held globally under custody or administration ("AUCA").[1]

While we agree with many of the fundamental risk mitigating precepts and initiatives embodied in the Proposed Rule, we believe the proposed limits on single-counterparty credit exposures (the **"SCCL"**) require a fundamental rethinking by the Board. In particular, credit exposure measurement methodologies for securities lending and similar transactions[2] developed to comply with the Basel II advanced approach should be permitted under the SCCL. The Custody Banks and the Board have made significant investments in developing these methodologies, and they provide the most accurate measurements of credit exposure for securities lending exposures.

1 Based on regulatory filings as of December 31, 2011.

2 While our comments today focus most specifically on securities lending, they apply more generally to the range of similar activities, such as those defined under Regulation Y as "repo-style transactions" (a repurchase or reverse repurchase transaction, or a securities borrowing or securities lending transaction, including a transaction in which the bank holding company acts as agent for a customer and indemnifies the customer against loss.) or under Basel III as a "securities financing transaction" (repurchase agreements, reverse repurchase agreements, security lending and borrowing, and margin lending transactions).

In several key areas, including the calculation of credit exposure related to securities lending, the Proposed Rule is significantly different than those adopted outside the United States. As a result, the Proposed Rules could unnecessarily create a significant competitive disadvantage for U.S. custody banks, harming the interests of both the Custody Banks and institutional investors on a global basis.

Executive Summary

The Proposed Rule should reflect a balanced approach: addressing potential systemic risks posed by counterparty exposures, while also accurately measuring those exposures and, to the extent feasible, avoiding negative consequences to financial markets. In several important respects, the Proposed Rule does not do this, and risks impeding the market stability and efficient operation of markets that flow from well-managed custodial banking operations.

In particular, we are concerned that the Proposed Rule:

- Overstates credit exposures associated with securities lending and similar activities;
- Fails to treat and exempt high credit quality foreign sovereigns in the same manner as the U.S. Government;
- Does not include an exemption for temporary operational exposures; and
- Relies upon an unworkable definition of "control" for purposes of aggregating affiliates of covered companies and counterparties.

The proposed calculation of credit exposure resulting from securities lending transactions is of particular concern to the Custody Banks. The proposed SCCL vastly overstates the actual risk of this activity, resulting in reported net credit exposures many multiples higher than exposures calculated using accepted, Board-approved measures. The Proposed Rule's overstatement of securities lending exposures will force a significant contraction in the size of the securities lending market, reducing revenue to asset owners (including mutual funds, pension funds and other collective investments), and negatively impacting market liquidity.

Furthermore, we are concerned that the Proposed Rule could significantly damage the competitive position of U.S. financial institutions relative to their non-U.S. peers that do not have to abide by the proposed SCCL. Institutional asset owners (such as mutual funds and pension funds) view agency securities lending as a traditional and integral part of custodial services. Denying or unduly limiting the ability of U.S.-domiciled banks to provide such services due to inaccurate exposure calculations could – since securities lending is an integral part of the custodial relationship – risk a restructuring of the entire traditional custody relationship, or incent asset owners to seek alternative non-U.S. custodians that are not subject to the restrictions of the SCCL.

Our detailed comments regarding each of these concerns are outlined below.

This commentary is divided into five parts. Part I provides an overview of securities lending transactions, including discussions of related benefits and the current regulatory treatment of securities lending exposures. Part II addresses the Custody Banks' substantive concerns with the Proposed Rule's approach to securities lending exposures. Part III outlines our concerns with the treatment of foreign sovereign counterparties. Part IV explains payments and settlement activities engaged in by Custody Banks and the need for changes to the Proposed Rule to accommodate operational overdrafts that may arise. Part V discusses our concerns with the proposed definition of "control" for subsidiaries. Included in Appendix A are specific examples of the operational exposures addressed in Part IV. Last, where appropriate, each part provides recommended revisions to the Proposed Rule.

Part I: Securities lending is a well-established and important component of the global financial system.[3]

Securities lending is necessary to facilitate the efficient operation of global settlement systems, increase market liquidity and provide asset owners with additional revenue. The Custody Banks are important participants in these markets, facilitating the lending of securities held by pension funds, mutual funds and other asset owners to market participants who need to borrow securities to ensure trade settlement, cover short positions and execute hedging strategies. It is common practice for custody banks to provide indemnifications against borrower defaults to the lenders of securities. This has historically been a low-risk activity that reduces complexity and risk for asset owners.

A. Benefits of Securities Lending to Financial Markets

Securities lending is critical to the functioning of global financial markets. In addition to providing incremental investment returns to asset owners, securities lending plays an important role in ensuring that securities trades settle on time, and in facilitating market making and other trading activities. It also allows asset borrowers to use short sales to more efficiently hedge risks, manage duration and execute strategic and tactical asset allocation strategies, among other things.

The benefits of securities lending to the marketplace are well recognized by regulatory authorities, including the Federal Reserve Bank of New York, Bank of England, Bank of Canada and CPSS-IOSCO, who have noted that:

- "Securities lending markets play central roles for both fixed income and equity markets. Repo and securities lending markets are especially important for allowing arbitrage in the Treasury, agency, and agency MBS markets, thus enhancing price discovery, efficiency, and market liquidity. Securities lending markets play crucial roles for allowing shorting of securities."[4]

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[3] For a more detailed discussion, see the comment letter filed by the Securities Lending Committee of the Risk Management Association (hereinafter, the "RMA comment letter"), which we endorse.

[4] Federal Reserve Bank of New York - Staff Reports – Repo and Securities Lending (January 2012).

- "The vanilla securities lending market is straightforward and important: it intermediates the loan of securities (equities, bonds or whatever) by asset managers to short sellers who need to deliver securities to settle their transactions. Securities lending is absolutely vital to effective market making, and thus to efficient capital markets."[5]

- "Securities lending contributes to effective market-making, increases overall market liquidity, and enhances the efficiency of price-discovery mechanisms in cash markets by allowing market-makers and investors to take on and cover short positions as part of their market-making activity, their investment and trading strategy, or for hedging purposes. Securities lending also increases the flexibility of financing for various market participants by facilitating the exchange of a broad range of securities, such as corporate bonds, convertible securities, and deposit notes for securities of higher quality that can be used in repurchase (repo) financing transactions. Alternatively, securities may be borrowed in exchange for cash, which can then be invested in the repo market or in other short-term assets."[6]

- "Securities lending plays an important role in supporting financial markets and brings positive benefits to the financial system….Securities lending can improve market liquidity, potentially reducing the cost of trading and increasing market efficiency. This enables better price discovery and can reduce price volatility, which can facilitate financial institutions and non-financial companies in raising funding and capital and also helps investors to buy and sell securities. By creating access to securities already outstanding in a market, securities lending has the effect of increasing the total supply of securities available to support activities such as market-making and trade settlement."[7]

- "Securities lending and borrowing (or repurchase agreements and other economically equivalent transactions) should be encouraged as a method for expediting the settlement of securities transactions. Barriers that inhibit the practice of lending securities for this purpose should be removed."[8]

B. Current Regulatory Treatment of Securities Lending Exposures

Credit exposures resulting from securities lending activity have long been subject to supervisory oversight and addressed through regulatory capital requirements[9]. In

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5 Paul Tucker, Governor of the Bank of England, - "Shadow Banking, Financing Markets and Financial Stability" (January 2010).

6 The Role of Securities Lending in Market Liquidity – Bank of Canada – Financial System Review – June 2010.

7 Developments in the Global Securities Lending Market – Bank of England Bulletin – Q3 2011 (Dive, Hodge, Jones).

8 CPSS-IOSCO – Recommendations for Securities Settlement Systems (November 2001).

9 This is the case under Basel I, Basel II, supervisory oversight of credit utilization programs, and will continue to be the case under Basel III.

addition, several pending regulatory initiatives, including rulemaking pursuant to Section 984 of Dodd-Frank and the current Financial Stability Board "shadow banking" work stream, focus on issues related to transparency, cash collateral reinvestment, and the potentially procyclical impacts of margin requirements. In addition, other reform measures in the U.S. make most major securities borrowers subject to the same capital and leverage restrictions as agent lender banks.

Securities lending transactions are over-collateralized and marked-to-market daily. Most transactions are of very short duration, typically overnight. Existing regulatory capital calculation methodologies, which are also typically used in internal credit utilization models, add an additional level of conservatism, and require banks to recognize the potential future market volatility in both the securities lent and collateral received, beyond that covered by overcollateralization. The Board's Regulation Y provides four options for bank holding companies to calculate counterparty credit exposure for securities lending transactions:

- Collateral haircut approach using standard supervisory haircuts;
- Collateral haircut approach, using Board approved internal estimates of haircuts;
- VaR methodology, using a Board approved VaR model to securities lent and collateral received within netting sets;
- Internal models methodology, using a Board approved internal model, based on estimated expected exposure applied to netting sets.

Firms actively involved in securities lending markets typically use the VaR methodology. These models, used by covered companies under Board supervision, have evolved over the years and possess several features that make them well suited to measuring credit exposures resulting from securities lending transactions, including risk sensitivity, appropriate assumed liquidation periods, and recognition of netting and correlation effects within netting sets. Even during the unusual volatility of the recent financial crisis, the VaR methodology performed well, as indicated by firm-specific back-testing. The VaR models demonstrate appropriately low credit exposures during times of low volatility, and increasing credit exposures during periods of market stress.

Existing VaR models satisfy the objectives of the Proposed Rule, as described in the preamble, by capturing "the market volatility (and associated potential increase in counterparty exposure amount) of the securities transferred or lent by the covered company in these transactions."[10]

Part II: The Proposed Rule overstates credit exposures associated with securities lending and similar activities.

The Proposed Rule's treatment of securities lending transactions appears loosely based on the collateral-haircut approach found in Regulation Y. As we understand the Proposed Rule, credit exposures resulting from a securities lending transaction would be calculated as:

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10 77 Fed. Reg. 594, 618 (Jan. 5, 2012).

- The market value of the securities lent, increased by an amount based on the Regulation Y standard supervisory haircuts; less
- The market value of collateral received, reduced by the Regulation Y standard supervisory haircuts.

The Proposed Rule would include an additional adjustment for cross-currency transactions and would allow limited netting under bilateral netting agreements.

The Custody Banks strongly oppose the proposed methodology for measuring securities lending exposures because it significantly overstates the actual exposures. This is the case for several reasons:

- **Lack of risk sensitivity** --- Both the Proposed Rule and the Regulation Y standard supervisory haircut approach use arbitrary, highly-conservative volatility haircuts. For banks active in securities lending, supervisory guidance has moved towards more granular, risk sensitive approaches for both risk measurement and capital calculation purposes. The mandatory use of arbitrary, fixed haircuts runs contrary to such guidance and to sound risk management practices. For this reason, banks active in securities lending do not typically use the collateral haircut approach, and have, instead, developed more risk sensitive VaR methodologies. In addition, the proposed approach provides no risk-sensitivity related to the duration of a securities loan. The great majority of securities loans are short in duration, greatly reducing the volatility risk that might be associated with the securities lent or the collateral received. Under the Proposed Rule, however, an overnight securities loan is treated identically under the SCCL as a similar loan with a much longer duration.

- **Inappropriate holding period** --- The Proposed Rule assumes a ten-day holding period to unwind securities lending transactions. Regulation Y, including the standard supervisory haircut method from which the Proposed Rule's haircut table is taken, more appropriately assumes a five-day holding period for securities lending transactions, and permits bank holding companies to adjust the standard supervisory haircuts accordingly.

- **Lack of recognition of netting** --- While the Proposed Rule includes language regarding permissible netting for securities lending transactions, our reading suggests that the provision, as drafted, provides very limited opportunities to net transactions, perhaps limited to netting individual CUSIPS within a netting set. Additionally, it does not appear to recognize the legal enforceability of commonly used netting agreements. Regulation Y, under the VaR methodology, more appropriately recognizes the netting applicable in measuring credit exposure to a counterparty.

- **Lack of recognition of correlation** --- The Proposed Rule does not recognize the correlation effect between securities lent and collateral received. Under the Proposed Rule, for example, the market values of similar, or even identical, securities lent and received as collateral are assumed to move in opposite directions in times of volatility. By contrast, Board-approved VaR methodologies under Regulation Y take correlations into account. This issue is particularly critical in non-U.S. markets, where the use of equities and non-cash collateral is common. The Basel III liquidity rules will result in the use of non-cash collateral becoming even more widespread.

The combination of these factors will result in a significant overstatement of credit exposure by a covered company to a securities borrower.

The Custody Banks have assessed the impact of the proposed haircut approach compared to current Board approved VaR methodologies on randomly generated portfolios of loans and collateral that are representative of a counterparty relationship[11]. The data show:

- For securities loans against cash collateral, the proposed haircuts produce exposures that are on average three times higher than the approved VaR estimates;

- For securities loans against a mixture of cash and non-cash collateral, the proposed haircuts produce exposures approximately ten times higher than the approved VaR estimates; and

- For securities loans against non-cash collateral, the proposed haircuts produce exposures that are about fifty-two times higher than the approved VaR estimates.

Thus, the proposed haircuts overstate credit exposures by many multiples --- a result confirmed by back-testing of actual client portfolios under the Proposed Rule. At the same time, the examples above demonstrate that the proposed haircuts are significantly biased against the receipt of non-cash collateral. Use of high quality non-cash collateral can reduce the risk exposure of the covered company due to the inherent correlation between such collateral and the loaned portfolio.

Using well-established Regulation Y methodologies would more closely align the Section 165 credit exposure calculation with actual economic exposure, and would greatly reduce the administrative burden on covered companies, while, consistent with the goals of Section 165, still preserve the level of conservatism underlying Regulation Y. Covered companies less active in securities lending, or otherwise not interested in seeking Board approval of more advanced approaches, would remain free to use Regulation Y's collateral haircut approach, which is similar to the approach in the Proposed Rule. Covered companies active in securities lending, or otherwise inclined to seek approval of more advanced approaches, would be able to adopt a more risk sensitive approach, consistent with their approach to regulatory capital. The Board, as under Regulation Y, would retain supervisory authority over the adoption of any approach which did not use the standard supervisory market risk volatility haircuts included in Regulation Y and the Proposed Rule. Such an approach would be consistent with the European Union's large exposure regime, which permits the use of all regulatory capital methodologies to measure credit exposure.[12]

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11 See RMA comment letter, *Appendix A*, for more details of this analysis.

12 Directive of the European Parliament and of the Council (2006/48/EC) Relating to the Taking up and Pursuit of the Business of Credit Institutions (Recast) – Title V, Chapter 2, Section 5 – Large Exposures

The Custody Banks understand the Board's interest in adopting simplified and uniform methodologies for Section 165. We believe utilizing existing Regulation Y methodologies accomplishes these goals. Should the Board decide against using Regulation Y, however, and seek to adopt an alternative that provides greater standardization across the industry, we would recommend that the framework of a VaR approach be maintained, but used with a series of standardized inputs that reflect the impact of legally enforceable netting agreements, as well as observable data related to asset classes and correlations. Such an approach would be superior to the proposed haircut approach, which unless drastically modified, results in massive overstatement of the risks associated with securities lending. Any "standardized input" approach, should at a minimum, be risk sensitive; assume appropriate holding period; recognize netting; and account for correlations.

Custody Bank Proposal:

We urge the Board to revise the Proposed Rule to align the counterparty exposure methodology applicable to securities lending with existing risk-based capital requirements, and to allow covered companies to use any of the permissible credit measurement methods under Regulation Y to calculate exposures to securities lending and similar transactions under the SCCL.

Part III: The Proposed Rule fails to treat and exempt high credit quality foreign sovereigns in the same manner as the U.S. Government.

We have significant concerns with the treatment of high credit quality foreign sovereigns as counterparties under the Proposed Rule. The inclusion of high credit quality foreign sovereigns as counterparties subject to the limit is unnecessary, contrary to other existing and emerging regulatory mandates, and will increase, rather than decrease systemic risk.

Though the application of the proposed counterparty limits to all high credit quality foreign sovereigns is of concern to all covered companies, the impact would be particularly problematic for the Custody Banks, due to the nature of the role we play in the global financial system, and the structure of our balance sheets. Specifically, the Proposed Rule would impact our ability to:

- Prudently manage covered companies' balance sheets, which, for custody banks are liability-driven (based on custody deposits), and therefore require high levels of investment in generally liquid, high credit quality assets, including foreign sovereigns.

- Comply with increasing non-U.S. liquidity requirements to hold foreign sovereign obligations in connection with non-U.S. entities – in currencies for which the Federal Reserve does not currently provide access to foreign exchange swap facilities, and in jurisdictions with different days of business and cut-off times.

- Place excess foreign denominated temporary liquidity (resulting from custody services) with foreign central banks, which will likely require us to convert to U.S. dollars and place with the Federal Reserve.

- Accept high credit quality foreign sovereign collateral, particularly in relation to indemnified non-U.S. securities lending transactions. Effectively requiring banks to decline high credit quality collateral, and instead accept lower credit quality alternatives, is particularly troublesome and contrary to sound risk management and credit principles.

Limiting our ability to invest in or accept collateral issued by foreign sovereigns will amplify systemic risk in times of stress, by forcing the Custody Banks to swap out of excess non-U.S. currencies at any price and hold excess USD at the Federal Reserve. Doing these things would reduce liquidity in the markets and put upward pressure on spreads.

In addition, the limitations upon non-U.S. sovereign exposures are inconsistent with the policy supported by both U.S. and non-U.S. regulatory authorities to employ a cleared, rather than bilateral, model for derivatives transactions. By limiting the amount of high quality sovereign debt that may be accepted as collateral, the Proposed Rule limits the ability of U.S. banks to participate in the emerging new derivatives marketplace.

The Proposed Rule should be modified to provide an exemption for high credit quality sovereign debt and securities. We understand the challenges involved with enacting regulations defining such "high credit quality" sovereign exposures, particularly in light of Section 939A of the Dodd-Frank Act, which prohibits regulatory use of credit ratings. Nevertheless, there are numerous existing or proposed regulatory regimes which could be used to define high credit quality sovereign exposures for purposes of Section 165. We note, however, that exposures to such sovereigns would still be subject to Board oversight, as part of covered companies' risk management practices.

Custody Bank Proposal:

We urge the Board provide an exemption for high credit quality sovereigns, based on the following criteria:

- Exempt all foreign sovereigns with an Organisation for Economic Co-operation and Development (**"OECD"**) Country Risk Classification of O with the exception of sovereigns that:
    - Have defaulted on any exposure during the previous five years;
    - Are currently participating in an IMF supported financial assistance program; or
    - Are not traded in an active two-way market with high trading volumes.[13]

[13] These conditions would make the Proposed Rule congruent with the recent Board Notice of Proposed Rulemaking on Risk-Based Capital Guidelines: Alternatives to Credit Ratings for Debt and Securitization (...continued)

- Exempt all central banks in countries meeting the criteria above.

Part IV: The Proposed Rule does not include an exemption for short-term operational exposures.

A. The Custody Banks provide well-regulated, low-risk, and essential services to smooth global payments and settlements.

It is essential to the operation of global payment and settlement systems that custodial banks be able to incur short-term counterparty exposures related to core transactional services, exclusive of the SCCL limit and without prior regulatory approval. We provide custodial and administrative services to institutional investor clients (including pension funds and mutual funds). A core part of such services is the ability to make and receive payments related to the settlement of securities, foreign exchange, and other market transactions. We also facilitate, on behalf of our institutional investor clients, the receipt of investment-related income, subscriptions and redemptions, and other routine payment services.

The Custody Banks each have a robust risk framework to set internal limits and address limit exceptions and other aspects of the custody and administrative services they provide on behalf of their customers. This includes policies and procedures adopted in accordance with supervisory guidelines that govern the extension of immediate or provisional credit to facilitate day-to-day transactional services. Nearly all transactions undertaken for institutional investor clients settle as expected and result only in intra-day exposures that are excluded from the SCCL limit under the Proposed Rule.

Occasionally, however, a transaction may be delayed or fail due to timing, matching, system or similar operational irregularities. As a result, a large temporary operational exposure to a counterparty (usually another large financial institution) may occur, which, if added to all other exposures to the counterparty, would result in exceeding the SCCL. These exposures usually arise due to unexpected operational occurrences. Since these exposures generally only become apparent after relevant cut-off times, it is beyond the reasonable control of the Custody Bank to reduce or eliminate the exposure or move the exposure to another counterparty on an intra-day basis. Usually, these exposures are resolved the next business day; in some cases it may take several days to resolve the issue. The attached Appendix A illustrates some of the circumstances that may result in large short-term operational exposures.

The custodial and administrative services the Custody Banks provide to our institutional investor clients, including provisional extensions of credit, are integral to global payment and settlement systems. These services are encouraged by prudential supervisors as a way to avoid bottlenecks that could hamper the efficiency of financial markets and exacerbate potential systemic risk. Payment and settlement systems in the

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Positions (76 Fed. Reg. 79380); European Central Bank Decision ECB/2012/4 (March 21, 2012); and the liquidity risk management criteria of Section 165(c) of Dodd-Frank, respectively.

U.S. are subject to supervision and oversight of their procedures and risk management framework under applicable Board requirements, including the Policy on Payment System Risk.[14] Upon their designation as financial market utilities, such systems will also be required to comply with regulations issued pursuant to Title VIII of the Dodd-Frank Act.

B. The Proposed Rule could disrupt global payment and settlement systems.

If the proposed rule includes custody-related transactional services as covered exposures <u>and</u> requires prior approval from the Board in order to exceed the limit, the Custody Banks will face significant restrictions on their ability to support essential payment or settlement activities. As a result, there will be considerable unintended market disruption, increased systemic and operational risks, customers will be disadvantaged and they will encounter higher levels of failed transactions. Requiring the Custody Banks to operate on behalf of their clients – without the ability to extend short-term transactional credit in excess of the SCCL – would necessitate fundamental changes in current practices that would heighten systemic risk, increase costs and disrupt market efficiencies. U.S.-based firms would also be at a significant competitive disadvantage because non-U.S. firms are not bound by the onerous requirements of Section 165(e). The results would not be in the public interest or consistent with the purpose s of the statute.

There is ample precedent for regulatory flexibility in dealing with transactional payments in relation to counterparty exposure limits, particularly when those exposures are to large counterparty banks. Regulations issued under the National Bank lending limit include an exception for, "amounts paid against uncollected funds in the normal process of collection."[15] Likewise, the Board's own Regulation F addresses limits on interbank liabilities and excludes from the definition of "credit exposure" any, "exposure related to the settlement of transactions, intra-day exposure, transactions in an agency or similar capacity where losses will be passed back to the principal or other party, or other sources of exposure that are not covered by the capital adequacy guidelines."[16] Regulation F also requires that a bank structure its transactions so that the exposure "ordinarily does not" exceed the internal limit, but permits "occasional excesses resulting from unusual market disturbances, market movements favorable to the bank, increases in activity, operational problems, or other unusual circumstances."[17]

It is also significant that the European Union's Capital Requirements Directive ("CRD") recognizes the need for flexible treatment of operational and payments-related exposures.[18]

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14 *See*, "Federal Reserve Policy on Payment System Risk" (as amended effective March 24, 20111), available at: http://www.federalreserve.gov/paymentsystems/files/psr_policy.pdf.

15 12 CFR Part 32.

16 12 CFR Part 206.

17 *Id.*

18 *See generally*, Article 106 of the CRD, which provides in pertinent part that "Exposures shall not include:(a) in the case of foreign exchange transactions, exposures incurred in the ordinary course of settlement during the two working days following payment; (b) in the case of transaction s for the purchase or sale of securities, exposures incurred in the ordinary course of settlement during the five working days following payment or delivery of the securities, whichever is earlier; (c) in the case of the provision of money transmission including the execution or payment services, clearing and settlement in any currency and correspondent banking or financial instruments clearing, settlement and custody services to clients, delayed receipts in funding and other exposures arising from client activity which do not last longer than the following business day; or (d) in the case of the provision of money transmission including the execution of payment

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Consistent with implementing guidelines issued by the Committee of European Banking Supervisors in the context of the EU large exposure regime (July 2010), it is important for an exemption to reflect the transactional nature of the credit exposures incurred by Custody Banks on behalf of their institutional investor clients. More specifically, it is possible that aggregate exposure to a single counterparty may exceed the SCCL limit for a period of several days, even though the initial transactions causing the exposure may have cleared, due to additional day-to-day transactional activities. Custody Banks must therefore have the flexibility to incur additional transactional exposures to a single counterparty when SCCL limits are exceeded, provided that policies and procedures are in place to reduce the excess exposure as quickly as reasonably practical and in any event within a specified short period of time (for example, ten business days) of the day that the excess first occurred.

Custody Bank Proposal:

We urge the Board to modify Section 252.97 of the Proposed Rule to include an exception that would exclude credit exposures to a counterparty in connection with payment or settlement activities in the ordinary course of business, including foreign currency, securities, derivative, commodity and similar market transactions, subject to certain controls that may include the following:

(i) The exposure arises in the normal course of providing payment or settlement services for investment-related transactions, including foreign exchange, securities, derivatives, commodities and similar transactions;

(ii) The covered company has policies and procedures that appropriately govern the credit and liquidity risks of the counterparty, exposures related to payments and settlements, and that monitor exposures daily;

(iii) To the extent that the aggregate exposure to the counterparty exceeds the SCCL, the covered company takes appropriate action, consistent with safety and soundness considerations, to reduce the excess exposure as quickly as reasonably practicable and in any event within ten business days of the day the excess first occurred; and

(iv) The covered company reports the excess exposure to its primary Federal regulator not later than the first business day after the excess occurs, and advises as to actions it has taken or will take to eliminate the excess exposure consistent with the ten business day timeframe specified above.

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services, clearing and settlement in any currency and correspondent banking, intra-day exposures to institutions providing those services."

Part V: The Proposed Rule relies upon an unworkable definition of "control" for purposes of aggregating affiliates of covered companies and counterparties.

The Proposed Rule requires a covered company to aggregate its exposures to a counterparty by incorporating exposures between the covered company and its subsidiaries and the counterparty and its subsidiaries. Section 252.94 of the Proposed Rule defines "subsidiary" to include companies that are "directly or indirectly controlled by" a covered company. In turn, such control is deemed to exist when a company (i) owns, controls, or has power to vote 25% or more of a class of voting securities of the company; (ii) owns or controls 25% or more of the total equity of the company; or (iii) consolidates the company for financial reporting purposes.[19] Implementing such a standard is unnecessary for policy reasons and unworkable in practice.

The fundamental objective of limiting exposures to individual counterparties is to ascertain potentially problematic interconnectivity between financial institutions. By definition, such a policy is only meaningfully advanced if the measurement standards focus on subsidiaries that are relevant to repayment risk. The Proposed Rule's overly broad designation of control should be revised to avoid capturing minority investments of counterparties that do not result in any potential assumption of liability if the subsidiary were to experience stress or fail.

The Proposed Rule assumes covered companies have knowledge and access to information that they do not, which renders the "control" standards unworkable in practice. The Proposed Rule, in its attempt to ambitiously aggregate subsidiaries to their parent companies, appears to presume that a covered company has deep and perpetual knowledge of counterparties' business structures. Not only is this an initial presumption – that is, it is presumed when an exposure is created – it is also a perpetual obligation, in that the Proposed Rule assumes a covered company has the means to know, at all times, the scope of every counterparty's minority investments. Such concerns with imputing granular counterparty knowledge to a covered company become even more problematic in the context of investment funds and limited partnerships, which function with far more fluid "ownership" structures.

Modifying the Proposed Rule to replace the proposed "control" standard to one predicated solely on consolidation for financial reporting purposes would more accurately capture the credit exposures central to legitimate supervisory concerns and create a more pragmatic framework.[20]

Custody Bank Proposal:

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19 *See*, §§ 252.94(i) of the Proposed Rule.

20 In addition to facilitating more accurate measuring and reporting of counterparty exposures, using a majority ownership standard would eliminate inaccurate overstatements of exposures that would result from applying the methodology to joint ventures.

We urge the Board to revise the definition of "control" to include only those entities that are consolidated with the relevant company for financial reporting purposes[21] and in which the relevant company owns a majority interest of the voting shares.[22]

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In summary, we urge the Board to modify the proposed SCCL to:

1) Align the measurement of credit exposure for securities lending and similar transactions with existing regulatory capital measurements;
2) Add an exception from the SCCL for high credit quality sovereign exposures;
3) Add an exception for temporary custodial or operational SCCL overages that occur in the normal course of business; and
4) Revise the definition of "control" to align with financial reporting.

These issues are particularly relevant to the provision of critical custodial banking services. We are concerned that the Proposed Rule will negatively impact our ability to provide services to institutional investors, and could increase, rather than decrease, systemic risk. We urge the Board to adopt the revisions suggested above.

Should you have any questions, please feel free to contact: Heather Koenig (BNY Mellon, Global Regulatory Counsel, (212) 635-7399), James Roselle (Northern Trust, Associate General Counsel, (312) 444-7565) or Nancy Loucks (State Street, Executive Vice President and Head of ERM, (617) 664-3997).

Sincerely,

Brian G. Rogan	Jeffrey D. Cohodes	Andrew Kuritzkes
Vice Chairman and Chief Risk Officer	Executive Vice President and Chief Risk Officer	Executive Vice President and Chief Risk Officer
The Bank of New York Mellon Corporation	Northern Trust Corporation	State Street Corporation

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[21] For the purposes of this commentary, consolidation for financial reporting purposes means consolidation under U.S. Generally Accepted Accounting Principles or the equivalent accounting regime in non-U.S. jurisdictions.

[22] In addition, in response to the second part of Question 25 of the Proposed Rule, we urge the Board to clarify that in no event should exposures to a company "controlled" (within the meaning of the Proposed Rule) by a foreign sovereign entity be included in the exposure to that foreign sovereign entity.

Appendix A --- Custody/Operational Exposure Example

Sub-custodian Example

Custody banks maintain extensive relationships with other financial institutions that serve as sub-custodians in markets in which our customers choose to invest. The custody bank's credit extensions to such entities might include short-term and time deposits and foreign exchange, among other services. The sub-custody arrangement may also require the counterparty to act as the custody bank's nostro agent for Continuous Link Settlement (CLS), treasury and foreign exchange settlements in a given market. While ongoing credit exposure is maintained at manageable levels, failed settlements can drive significant swings in exposure as measured under the Proposed Rule.

Let's assume, for illustrative purposes, that the counterparty is a large, high credit quality EU bank ("Bank A") that serves as the custody bank's sub-custodian in Bank A's home country ("Country Y"). We'll also assume that the counterparty's general SCCL runs at about 19% of the custody bank's total capital. However, on a given day, several events occur:

- Bank A's home market has had healthy economic growth, such that its currency is typically strong and generally rising against the US Dollar. However, general market stress has made the currency more volatile and the bank's foreign currency exposure has increased foreign exchange-related exposure by an amount equal to an additional 3% of the custody bank's capital for the day as investors take refuge in the US Dollar.

- A custody bank client - a long-only, unleveraged Sovereign Wealth Fund (SWF) - has purchased equities equivalent to 10% of the custody bank's capital in Country Y, which the SWF has funded via proceeds of FX trades that settled through CLS early in the morning. However, the equity seller's broker is unable to deliver the equities for cash settlement. Thus, unexpectedly at the end of day, the custody bank has a very large long position in its nostro account at Bank A. As a result, the custody bank Bank A exposure increases by an additional 10% of capital.

Other factors, including the end-of-day value assigned to securities collateral, could raise the risk of an increase in the SCCL even more, albeit temporarily. In any event, the events could cause the bank to exceed its 25% SCCL. Regardless of the collateral available to protect the custodian's position, the bank would be required to unwind certain trades, limit the security trades and take other actions in order to ensure it is not in violation at day's end, although certain market activities (*e.g.*, Federal Reserve book entry transactions) may make this difficult to manage. Such actions would cause a material impact on the markets and raise costs.

Pension Example

It is also common for a custody bank to have a relationship with large public and private pensions. The custody bank's credit exposure to such entities might include overdrafts and foreign exchange.

Let's assume that the counterparty is a large state pension with $200 billion in combined assets. We'll also assume that the counterparty's general SCCL runs at just 7% of the custody bank's total capital. However, on a given day, several events occur:

- An investment manager enters trades for US Treasury Bill purchases across a number of funds equaling less than 2% of the collective funds, but 20% of the bank's capital, with the intention of selling these to brokers under reverse repurchase agreements. The buy trades do not settle with the custodian until after 3:15 PM, which is too late to make delivery on the sell trade or "dk" the buy trades back to the broker. This would cause the custody funds to be long the T-bill positions, and the client's demand deposit accounts to be overdrawn.

- Monthly benefit payments totaling 15% of the bank's capital occur across a large number of accounts in the form of Fed wires. Individually, the wires settle automatically based upon settlement rules that take into account counterparty rating and NAV relative to the wire size, but failure of trades to fund the wires could result in overdrafts.

The likelihood of wholesale failed trades is low and the collateral protections afforded the custody bank are strong, but these combined events could cause the counterparty's SCCL, albeit temporarily, to rise well above the banks 25% limit. As such, the custody bank would be required to either withhold payments or cancel buy-trade transactions, impeding legitimate market activity.

Corporate Example

It is also common for a custody bank to maintain relationships with very large and established multi-national corporations that can create very large intra-day exposures that are small relative to assets under custody, but large relative to the custody bank's capital.

Let's assume, in this case, that one of these corporate counterparties is a very large, public and profitable US-based multi-national technology company with modest debt on its balance sheet and vast liquid investments, including a $60 billion investment portfolio custodied at the bank. In addition, the custody bank participates in an undrawn committed revolving credit facility to Company A, has a foreign exchange trading limit with the Company, and holds some of its equities as collateral in securities finance transactions, equal to 8% of bank capital.

Company A disburses payroll twice monthly and bonuses twice annually. This is accomplished by the custody bank remitting funds out of Company A's custody account from the proceeds of maturing T-bills, repos and other investment maturities to Company A's payroll disbursement agent ("ACH Bank"), which requires all amounts to be funded by 10 AM. While T-Bill maturities settle early in the morning, settlement of repo maturities is usually in the afternoon, causing intra-day overdrafts. When both payroll and bonuses are being paid, it is not uncommon for these intra-day exposures to total more than 25% of custody bank's capital. Other less common but perfectly valid financial activities, like a wire to complete a large acquisition that to be funded in a similar manner, might also serve to raise the total further. Although the entire exposure will likely exist only intra-day, and thus excluded from limits, and despite the collateral protection afforded the custody bank through its custody of the investment portfolio, the bank would be prohibited from funding the wire if there is a risk that failed repo settlements could cause the intra-day exposure to become an overdraft that brought overall exposure over the 25% limit. In such an instance, Company A would be forced to seek spread transactions over multiple days, increasing costs. Alternatively, it could seek services from a bank either not subject to these limits or with a sufficiently high enough capital base to support the wire transfer, concentrating more of such exposures with larger institutions.