BNY MELLON Northern Trust STATE STREET

October 22, 2012

Board of Governors of the Federal Reserve System
20th Street & Constitution Avenue, N.W.
Washington, D.C. 20551
Attention: Jennifer J. Johnson, Secretary
Docket No. R-1442
RIN 7100,AD 87

Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington D.C. 20429
Attention: Comments/Legal ESS
RIN 3064-AD95, 3064-AD96, 3064-D97
Attention: Robert E. Feldman, Executive Secretary

Office of the Comptroller of the Currency
250 E Street, S.W.
Mail Stop 2-3
Washington, D.C. 20219
Docket IDs OCC-2012-0008, OCC-2012-0009, OCC-2012-0010
RIN 1557-AD46

Re: Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action: Standardized Approach for Risk-weighted Assets, Market Discipline and Disclosure Requirements: Advanced Approaches Risk-based Capital Rule

Ladies and Gentlemen:

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 with respect to the Notices of Proposed Rulemaking (the **"Proposals"** or the "**Proposed Rules**") issued by the Board of Governors of the Federal Reserve System (hereinafter, the "**Federal Reserve**"), the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation (all three entities collectively comprise the "**Agencies"**) to revise and replace capital rules for U.S. banks and bank holding companies. In general, the proposed new capital rules would adjust risk-weightings for myriad asset classes, redefine what instruments qualify as components of regulatory capital, and establish new required minimum capital levels. The Custody Banks support efforts to improve the resilience of the U.S. financial system through the introduction of more consistent and robust regulatory capital standards. During the financial crisis too many financial institutions lacked the ability to absorb losses due to market shocks, asset concentrations or other idiosyncratic risks.

Since the market turmoil of 2008-2009, the Custody Banks have significantly improved the quality and quantity of our capital. We have also invested in enhancements to our modeling capabilities and the development of comprehensive stress testing programs to ensure the resiliency and strength of our balance sheets. While we are generally supportive of the proposed new capital framework – particularly the approach the Agencies have taken with regards to the capital buffers – we do believe that certain areas require adjustments. In particular, we believe that the treatment of securities lending transactions; the imposition of a new supplementary leverage ratio; the scope of transactions deemed to be securitizations; the application of supervisory formulas to these exposures; the removal of the filter on unrealized gains and losses in regulatory capital; and the asset value correlation multiplier all require fundamental rethinking.

Executive Summary

The Custody Banks believe that capital reforms should reflect a balanced approach: ensuring capital adequacy while retaining the supervisory commitment to risk-sensitivity and meaningful capital metrics. The Proposals do not completely satisfy this standard. Rather, despite a proliferation of new ratios, changes to existing methods for calculating risk-weighted assets, and revisions to the permissible components of regulatory capital, many of the Proposals' provisions will decrease risk-sensitivity and present an inaccurate picture of bank balance sheets.

In particular, we are concerned with the Proposals' treatment of securities finance, insofar as they:

- Prohibits banks from using the Simple VaR or internal modeling methods under the Standardized Approach to calculate exposures arising from securities lending[1];

- Diverges from the Basel III Accord by requiring all exposures to securities firms to be treated as corporate exposures;

- Mandates that banks assume a twenty business day holding period for collateral for netting sets, if the total number of trades exceeds 5,000 at any time during a quarter; and

- Improperly and expansively defines margin disputes.

Beyond securities finance, the Proposals would:

[1] 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, where the value of the transactions depends on the market valuations and the transactions are often subject to margin agreements").

- Implement a new, supplementary leverage ratio that will confuse the public, analyst, and investor communities while providing little benefit to supervisors;

- Define "securitizations" in an unduly broad manner;

- Overstates the risk associated with certain securitization exposures that require application of the simplified supervisory formula approach (the **"SSFA"**);

- Compel the recognition of illusory gains and losses on available-for-sale security ("**AFS**") portfolios by eliminating the regulatory capital filter applied to accumulated other comprehensive income (**"AOCI"**); and

- Require the use of asset value correlation factors that exaggerate correlation risks.

Our detailed comments regarding each of these concerns are set forth below.

This commentary is divided into seven parts. Part I endorses the Agencies' approach to coordinating the application of Section 171 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Dodd-Frank Act,**" of which Section 171 is known as the "**Collins Amendment**") with internationally agreed upon capital buffers. Part II provides an overview of securities lending transactions, including discussions of related benefits and the current regulatory capital treatment of such lending transactions. Part III addresses the Custody Banks' substantive concerns with the Proposed Rules' approach to securities lending. Part IV discusses issues with the supplementary leverage ratio. Part V explains the securitization-related activities of Custody Banks and related concerns. Part VI covers the removal of the AOCI filter. Part VII explains our concerns with the asset value correlation factor. Where appropriate, Parts III through VII contain our recommendations for revising the Proposal.

Part I: The Advanced Approaches Proposal correctly dictates that capital conservation buffers and any future applicable buffer should be calculated using advanced approaches risk weightings.

The Proposed Rules state that banking organizations subject to the advanced approaches rule must calculate their capital conservation buffer and any future operative buffers using advanced approaches total risk-weighted assets. We agree with this approach. Advanced approaches methods most effectively capture the individual risk profiles of banking organizations. Under advanced approaches methodologies, banking organizations calculate risk-weighted assets for credit, market and operational risk. The Custody Banks believe that the inclusion of all three of these risk types in the advanced approaches methodologies results in a more comprehensive view of a banking organization's risk profile than does the standardized approach.

U.S. banking organizations that are internationally active, including the Custody Banks, would face significant competitive inequities if they are not permitted to use methods similar to their international competitors' for calculating their capital buffers. In other jurisdictions, notably the European Union, banking organizations are not required to use a Standardized Approach when calculating their risk-based capital. Additionally, as the Custody Banks have spent several years participating in external parallel run for the adoption of the advanced approaches requirements, their management teams and Boards of Directors have been utilizing advanced approaches methodologies to calculate risk-weighted assets as well as their capital adequacy under both Pillar 1 and Pillar 2 of the existing Basel framework. We feel that moving to a measurement of risk-weighted assets that is less sensitive to a banking organization's specific risk profile, as are risk-weighted assets calculated under the standardized approach, may undermine the significant efforts of both the regulators and banking organizations of the past several years.

We recommend that the Agencies introduce changes to the standardized and advanced approaches on a uniform basis. This reflects the dual risk-based capital standards that the Collins Amendment imposes on advanced approaches banks, which has the potential to greatly complicate industry compliance and also create unnecessary market confusion. More specifically, we recommend that both frameworks be made effective for U.S. banks as of January 1, 2015, the date currently specified in the Proposals for the introduction of changes to the Standardized Approach.

Part II: Securities lending is a well-established and important component of the global financial system.[2]

Securities lending services provided by the Custody Banks are critical to the global financial system. Such lending increases market liquidity, enhances price discovery and provides asset owners with additional revenue. The role of the Custody Banks is straightforward: we serve as intermediaries, 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. As a matter of standard market practice and notwithstanding our role as an intermediary, we provide securities replacement indemnification protecting lenders in the case of a borrower default resulting in a failure to return the borrowed securities. Many securities lenders are required by law or policy to obtain borrower default indemnification by agent banks, due to ERISA, state or municipal standards, foreign guidelines, or plan policies. Accordingly, elimination of the replacement indemnification would not be practical. Our securities lending transactions are appropriately collateralized and marked to market daily. This is a low-risk activity that reduces complexity and risk for asset owners and is regulated and supervised by prudential regulators as a traditional banking service.

[2] For a more detailed discussion, see the comment letter filed by the Securities Lending Task Force of the Risk Management Association, which we endorse.

The benefits of securities lending to the marketplace are well recognized by regulatory authorities, including the Federal Reserve Bank of New York (the "**FRBNY**"), Bank of England, Bank of Canada and CPSS-IOSCO. The FRBNY, for instance, noted in its January 2012 Staff Report: "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."[3]

Part III: The Proposed Rules' treatment of securities lending transactions and exposures is unnecessarily punitive.

We are concerned that the Proposed Rules could have several unintended consequences for the securities lending market. For providers of custody services, the Proposals are unduly punitive in their treatment of securities lending transactions. This is the case for several reasons: the prohibition on using Simple VaR or internal models to calculate capital requirements; increased risk-weightings for exposures to securities firms; new collateral holding period standards; and regulatory capital penalties for margin disputes. These provisions will increase costs, burden market participants and significantly impede market liquidity.

It is likely that these components of the Proposals will lead to lower volumes of securities lending transactions, which will not reduce interconnectivity and systemic risk, but instead will reduce market liquidity, inhibit price discovery and generally disrupt the U.S. capital markets. We believe that the existing regulatory capital framework applicable to securities lending transactions has proven to be rigorous and should be maintained.

A. The prohibition on using Simple VaR or internal models to calculate capital requirements will result in less sophisticated and arbitrarily inflated requirements.

The Federal Reserve's Regulation Y provides four options for bank holding companies to calculate counterparty credit risk for securities lending transactions:

- Collateral haircut approach using standard supervisory haircuts;
- Collateral haircut approach, using Federal Reserve approved internal estimates of haircuts;
- Simple VaR methodology, using Federal Reserve approved models;
- Internal models methodology, using Federal Reserve approved internal models, based on estimated expected exposure applied to netting sets.

The last two of these approaches are far superior to the Proposed Rules' use of standard supervisory haircuts or banks' estimates of haircuts to calculate relevant exposures. Moreover, in the securities lending space the financial crisis did not reveal any apparent modeling weaknesses on the part of market participants. The Standardized Approach

[3] Federal Reserve Bank of New York, Staff Reports: Repo and Securities Lending (January 2012).

Proposal itself contains no compelling data, policy, or safety and soundness reason why any of these options should be eliminated. Accordingly, the Custody Banks request that the Agencies reconsider their position and continue to allow the use of approved models-based approaches.

Firms actively involved in securities lending typically use the simple VaR methodology for risk management purposes. These models 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 simple VaR methodology performed appropriately. The model-based framework demonstrated a superior ability to measure the actual risks associated with securities lending transactions.

Why did a models-based approach perform admirably, even during times of crisis? In short, banks active in the securities lending market have spent years developing the features of these approved models and their comprehensive nature leads to less blunt and more risk-sensitive outputs. For instance, the use of models allows firms to account for risk mitigation (*i.e.*, correlation benefits), diversification and the shorter duration of most loans.

Prohibiting the use of models will have significantly deleterious effects on the securities lending market. Agent lenders will see capital requirements increase to exorbitant levels – perhaps as high as 15-20 times current requirements. It will be difficult for U.S. banks to compete with foreign agent lenders under such circumstances. Global competitive equity and long-held supervisory commitments to risk sensitivity demand that the Agencies reconsider the prohibition on the use of approved models under the Standardized Approach.

B. Increased risk-weightings for exposures to securities firms are unwarranted.

The Custody Banks believe that the current treatment of exposures to securities firms in the regulatory capital rules[4] is consistent with the Basel III Accord and does not require modification. The text of Basel III expressly permits exposures to securities firms to be the same as exposures to other depository institutions – that is, subject to a 20% risk weighting – if certain criteria are met. We do not believe that the Agencies should electively raise the risk-weighting for such exposures to 100%, particularly given the historical record. Rather, we urge the retention of the 20% weighting, especially in the case of bank-affiliated securities firms.

The nature of our business models already require us to carefully consider idiosyncratic risks arising from concentration and counterparty considerations. Even so, there are a multiplicity of reform proposals and finalized new requirements that address this supervisory concern. For instance, in the United States, large Custody Banks are required to file resolutions plans and will have to comply with new single counterparty credit exposure limits mandated by Section 165(e) of the Dodd-Frank Act. At the global

4 12 C.F.R. Part 225, Appendix A.

level, both BNY Mellon and State Street have been designated as global systemically important banks and will be subject to a capital surcharge to address the potential negative externalities to the financial system associated with their potential financial stress. Without revisiting the suspect presupposition that interconnectivity was a contributing factor the financial crisis, we would note that unilaterally increasing risk-weightings for exposures to securities firms is duplicative and unnecessary. Moreover, it is a departure from the Basel framework that will disadvantage U.S. banks.

C. New collateral holding period standards are unclear and require revisions to account for normal market practices.

The Custody Banks acknowledge that the netting discussion contained in the Proposals follow the prescriptions of the Basel III Accord to the extent that it compels agent lenders (and others) to assume a holding period of 20 business days for collateral, where the number of trades exceeds 5,000 during a particular quarter. Even so, we believe that clarification is required to avoid unintended capital volatility. We recommend that the Agencies clarify that the 5,000 netting set threshold be calculated on a quarterly average basis rather than on the basis of any single breach above the designated threshold. In addition, we request clarification that the 5,000 threshold is calculated according to individual transactions in a netting set and not across the entire, aggregate client allocations of an agent bank.

D. Regulatory capital penalties for margin disputes will burden market participants and impede liquidity transformation

The Proposals dictate that if two or more margin disputes concerning a single netting set exist over a consecutive two-quarter period, the agent bank must use a holding period assumption that is at least twice the minimum assumption otherwise applicable to the netting set. This requirement is unnecessary. Most disputes are settled according to the contractual provisions of individual securities lending agreements. That is, it is difficult to conceptualize a "margin dispute" that would materially affect the risk of a netting set and require a commensurate increase in risk-based capital.

We are troubled by the entire premise upon which the margin dispute provision rests. The existence of two margin disputes with respect to a particular netting set over a two-quarter time horizon is not necessarily an indicator of any increased level of risk. Lenders and counterparties have ongoing discussions regarding appropriate margin levels and collateral practices. The plain text of the Proposal appears to turn some – if not all – of these normal business discussions into margin disputes. It is also important to note that the Custody Banks enter into securities lending arrangements that are over-collateralized, which significantly reduces the likelihood that in the event of any margin dispute, a particular netting set could represent true credit risk.

We believe that it is inappropriate to base significant holding period assumptions on the nebulous margin dispute standard the Agencies have proposed. Rather, we would endorse a revised standard that requires increases in holding period assumptions if one party to a securities lending transaction initiates formal legal action to remedy an alleged breach of the parties' contractual agreement.

Part IV: The proposed supplementary leverage ratio will create market confusion without providing offsetting supervisory benefits.

The Proposed Rules require advanced approaches institutions to satisfy a newly designed supplementary leverage ratio. The denominator of this supplementary leverage constraint includes certain off-balance sheet exposures that are not included in the existing U.S. leverage ratio. It is unclear to the Custody Banks what prudential concerns led the Agencies' to include this new leverage metric. Certainly we agree with the concept embodied in the Basel framework that all banking firms should be subject to a leverage requirement. We believe, however, that the existing U.S. leverage ratio sufficiently meets the expectations of the Basel Committee.

If the Agencies' concern is with undisclosed, pernicious industry practices that result in excessive off-balance sheet leverage, we believe it would be more sensible to better calibrate or modify the existing leverage ratio. Having two leverage ratios will only cause confusion among market participants and investors, without providing any material increase in safety or soundness.

The Custody Banks request that if the supplementary leverage ratio is retained, it should exclude any notional amount of unconditionally cancelable commitments. Unconditionally cancelable commitments are not credit exposures in the ordinary sense of the term because they can be extinguished at any time at the sole discretion of the issuing entity. Including such commitments masks the actual leverage of an institution,

In respect of the securities lending activities conducted by the Custody Banks, we appreciate the Agencies' decision to exclude indemnified securities lending exposures in the off-balance sheet measure of exposure for purposes of the supplementary leverage ratio, and we recommend that this approach be maintained.

We request that further dialogue between industry and supervisory authorities occur prior to any other course being selected.The borrower default indemnification provided in many agency securities lending transactions results in minimal off-balance sheet exposure for the Custody Banks. The Custody Banks' exposures are merely the difference, if any, between the daily mark-to-market value of posted collateral and the repurchase price of securities not returned (reduced further by excess margin). If securities lending transaction exposures are included at all in the denominator of the supplementary leverage ratio, they should only be included to the extent that the indemnification exposure exceeds the collateral coverage. Depending on the underlying methodology, inclusion of these off-balance sheet indemnifications in a supplemental leverage ratio could meaningfully limit the Custody Banks' ability to provide securities lending services.

Part V: The Proposed Rules' definition of "securitization" is over-inclusive and the application of the SSFA overstates the risks of certain securitization exposures and presents significant data challenges.

The Custody Banks are mostly supportive of the Agencies' efforts to adopt the components of the Basel framework that increase the amount of risk-based capital that must be held against securitization exposures. Generally speaking, the financial crisis revealed that securitization positions can pose greater risk to bank solvency than previously believed. This principle, while embodied in the Proposals, is undercut by the Agencies' reliance on an overly broad definition of "securitization." Ancillary to our concerns that the sweep of the securitization provisions is excessive is our concern that applying the SSFA, as proposed, will result in a significant overstatement of risk and will unnecessarily magnify capital requirements.

A. "Securitizations" are defined in an overly broad manner.

The Custody Banks believe that the proposed definition of a "securitization" is overly broad and includes multiple structures that are not securitizations. The proposed definition would, for instance, cover many investment funds and exposures to non-operating companies. The Proposal defers drawing clear boundaries by allowing primary federal supervisors to determine whether an exposure is a securitization or not, through considering "the economic substance, leverage, and risk profile of transactions." This determination "would be guided by the economic substance of a transaction rather than by its legal form." This after-the-fact, subjective determination does not provide sufficient clarity or certainty for robust and prudent capital management purposes. The Custody Banks are concerned that banking organizations may have to hold substantially higher levels of capital to compensate for this uncertainty.

We recommend that the Proposals exempt several specific exposures that are standard custody banking services and therefore bear none of the indicia of a traditional securitization. Such exposures include: overdraft loans, exposures arising from foreign exchange and settlement and clearing activities; and exposures arising from contractual income payments and certain non-tranched guarantees. In addition, we believe that the exemption for ERISA plans should be broadened to include state and other public pension plans, including foreign equivalents. These exposures are functionally and structurally similar to ERISA plans and are designed for the same underlying purpose: the accumulation of retirement and other employee benefits.

Under the Proposals, the existing deduction from regulatory capital in the general risk based capital rules is replaced in several instances with a 1,250% risk weight. The shift to a 1,250% risk weight is being done to reduce the differences in the measure of capital for purposes of the risk-based capital requirements as compared to the leverage capital requirements. However, this risk weight would impose a penalty on banking organizations with higher risk-based capital ratios and more robust capital positions. As observed in the commentary to the Advanced Approaches Proposal: "The more a risk-based capital ratio exceeds 8.0 percent, the harsher is the effect of a 1,250 percent risk weight on risk-based capital ratios. Conversely, the effect of a 1,250 percent risk weight would be less harsh than a deduction from total capital for any risk-based capital ratio that is below 8.0 percent."

Such an outcome and the incentives/disincentives generated by it are of concern to the Custody Banks and also runs counter to the very purpose of Basel III, Dodd-Frank, and other financial-reform initiatives that are driving banking organizations to build and maintain sizeable cushions of more expensive loss-absorbing capital. The aim of reducing disparities in the measure of capital for leverage and risk-based capital purposes can be achieved without sacrificing a meaningful incentive for banking organizations to maintain the healthiest of capital positions. The solution that we propose is simple and straightforward: a cap on the amount of risk-based capital that a banking organization must deduct for certain exposures, fixed at the amount of that exposure (*i.e.*, a dollar-for-dollar cap).

B. The proposed application of the SSFA overstates the risks of certain securitization exposures and presents significant data challenges.

Custody Bank balance sheets are different from those of more traditional commercial banks; we make fewer loans, but hold large amounts of investment assets. As a result, our balance sheets are uniquely sensitive to supervisory adjustments to the calculation formulae for securitized assets.

The SSFA is intended to meet the requirements of Section 939A of the Dodd-Frank Act, which requires the elimination of all references to credit ratings in U.S. banking regulations. The Custody Banks believe that the SSFA does not properly distinguish the quality of highly credit enhanced senior securitization tranches. This includes an almost three-fold increase in the minimum risk-weight floor for securitized assets. The SSFA can result in an overall capital charge that is higher if a banking organization held all tranches of a securitization than the capital required if the banking organization held all of the underlying loan exposures. It is foreseeable that this could create a disincentive to both securitizing originated exposures and owning securitization exposures, and is inconsistent with the policy objective of having capital standards calibrated to reflect actual risk.

Unlike the prevailing credit risk framework, the SSFA is not forward-looking, and the resulting risk weights are therefore subject to greater volatility over time. Credit ratings are based on forward-looking cash flow projections and only change when there are unexpected changes in a position's performance. In contrast, the SSFA recognizes performance changes only as they occur.

In addition to our general criticism of the SSFA, we believe that several discreet issues require supervisory attention. These concerns fall into three broad categories: data availability; issues involving re-securitizations; and the treatment of highly leveraged funds (**"HLFs"**) as securitizations.

i. Data Availability

The most pervasive concerns the Custody Banks have with the SSFA relate to data availability. Sophisticated investors in securitized assets subscribe to various structured finance data and analytical services, such as Bloomberg, Intex and Trepp. The capabilities provided by these systems allow for robust analysis, surveillance, and trading of structured finance securities. Data required for the SSFA inputs should consider – and be synchronized with – data that is generally available to sophisticated investors. The Proposals do not do this; rather, several proposed inputs would mandate parsing through more detailed, loan-level data. This is especially true in the case of residential mortgage-backed securities ("**RMBS**") where very fine distinctions are made, requiring access to detailed information on underwriting standards, loan to value ratios, debt to income ratios, loan modifications, second liens and delinquencies. Much of this data is only available through additional subscriptions to loan-level data providers, such as CoreLogic's LoanPerformance. For some securitized asset classes, such as many European securitizations, the level of granularity envisioned in the Proposals is unavailable.

The consequences of being unable to access the data can be severe. For instance, information that is required to identify a category 1 residential mortgage versus a category 2 residential mortgage can cause standard risk-weights to rise from 35% to 100%. The same issue exists for commercial mortgage-backed securities (**"CMBS"**). In addition to the lack of availability data, we have found material inconsistencies in the calculations produced by the most common sources of RMBS and CMBS data: Bloomberg and Intex. These data problems are relevant to key SSFA parameters, such as A (attachment point), D (detachment point), W (delinquencies) and Kg. As noted, further exacerbating our concerns with data availability is the fact that increasingly different interpretations of these parameters is causing material inconsistencies to develop.

The Custody Banks are concerned that if a banking organization experiences difficulties in obtaining data required to use the SSFA (for example, in the case of certain non-U.S. securitizations), they will be compelled to hold risk based capital well in excess of the true risk presented by the asset. As an initial matter, the Custody Banks therefore request the grand-fathering of existing general risk-based capital rules for RMBS issued prior to the publication of final rulemaking.

More broadly, where there are immaterial gaps in the data required to use the SSFA, banking organizations should be allowed to use proxy data, provided it represents a conservative estimate of actual data. This is particularly important in the context of foreign securitizations where there is little likelihood that the market will evolve to meet SSFA data standards[5]. This approach is consistent with the principle of conservatism, which permits a banking organization "not to apply an aspect of the [advanced approaches capital rules] for cost or regulatory burden reasons, if the result would be a more conservative capital requirement." If and when actual data becomes available to fill these immaterial data gaps, an advanced approaches banking organization would be required to replace the proxy data with actual data inputs for purposes of the SSFA.

We recommend that the Agencies allow institutions to use averages or accumulated data figures to redress these data problems. Such an allowance could draw on the data reporting requirements of the FDIC's assessments framework.

ii. Re-securitizations

The Proposed Rules incorporate a very broad definition of the term "re-securitization". Specifically, a 're-securitization' is defined as any securitization structure 'in which one or more of the underlying exposures is a securitization exposure', and includes both direct and indirect exposures. Instruments that are deemed re-securitizations are subject to an SSFA supervisory conversion factor of 1.5, versus the

[5] Examples of such structures include U.K. and Dutch RMBS. both of which have a long history of strong performance.

standard conversion factor of 0.5. Additionally, for re-securitizations, Kg is determined on the basis of the capital charge applicable to the underlying securitizations rather than on the basis of the underlying loans. While the Custody Banks acknowledge the concerns raised by the financial crisis relative to the performance of certain securitization structures, such as ABS collateralized debt obligations, which packaged investments in highly correlated, junior positions, we believe that the intended definition is too broad and may therefore unnecessarily limit the ability of banks to invest in certain high-quality securities. Not all re-securitization exposures are opaque or extraordinarily complex; to the contrary, many are, on a relative basis, clear and straightforward. We therefore recommend two targeted adjustments to the Proposals.

First, we recommend that the Agencies introduce a de minimus exemption for securitization structures that include a very limited amount of exposure to other securitizations. This includes collateralized loan obligations ("CLO") that typically hold a small amount of exposures to other CLOs, generally for risk diversification purposes. We believe that the current treatment of these types of exposures as re-securitizations is excessive, and also broadly incompatible with their underlying risk. In our view, it would therefore be appropriate for the Agencies to exclude from the definition of a re-securitization, any securitization exposure in which 5% or less of the underlying exposures is comprised of a securitization exposure.

Second, we are concerned that the intended definition of a re-securitization will capture securitization structures, such as re-REMICS, that involve one or more senior tranches of an underlying reference securitization. We view these securities as analogous to owning a super-senior or a senior mezzanine position in the underlying reference securitization and therefore question the appropriateness of their designation as a re-securitization. Indeed, this approach would create the perverse need for banks to hold much higher levels of capital for the re-securitized senior position of a securitization exposure than the underlying reference securitization. We therefore recommend that the definition of a re-securitization be further amended to require the presence of more than one underlying reference securitizations.

iii. Treatment of HLFs

It is unclear if the Proposals intend to apply the SSFA to HLFs and, if they do, what the application threshold would be. Like many banks, the Custody Banks sponsor funds that are leveraged to some degree. Under Basel II, banks are permitted to look-through such structures to the underlying assets in order to apply the most appropriate risk-weighting. It appears from the text of the Proposals, however, that all HLFs could be subject to a 1250% risk-weighting. What is unclear is the threshold that will lead to a fund being deemed "highly leveraged".

Many funds take on very little leverage even though, under the terms of their prospectuses, they could take on a significant amount of maximum leverage. We believe that the most appropriate measure is existing leverage; not the capacity a structure has to take on leverage. To that end, we recommend that the Agencies either clarify that the SSFA does not apply to HLFs, or, if it does apply, establish a threshold based on actual leverage used.

Part VI: The removal of the AOCI filter will compel the recognition in regulatory capital of gains and losses due to changes in interest rates, not credit risk.

The Agencies requested comment regarding the relative benefits of permitting banks to continue to exclude from regulatory capital "unrealized gains and losses on [available for sale] debt securities whose changes in fair value are predominantly attributable to fluctuations in a benchmark interest rate (for example, U.S. government and agency debt obligations and U.S. GSE debt obligations)."[6] The Custody Banks acknowledge that during the financial crisis regulatory capital levels at many institutions overstated the actual loss-absorbent capital held. This was, in part, the result of valuation changes that went unrecognized. The result was a loss of confidence by investors, counterparties, and the public in banks' stated capital levels. Still, we are concerned that the removal of the AOCI filter may introduce unnecessary capital volatility that could also negatively impact market confidence. This is especially true if the filter were fully removed, without regard to interest rate related movements in the value of assets.

The Custody Banks - like most banks – use our AFS portfolios to flexibly manage liquidity and interest rate risk. We also use these securities for asset-liability management purposes. It is axiomatic that we should be using high-quality government (or similar) fixed rate securities to reduce interest rate risk related to fixed-rate liabilities. Additionally, we would note that compelling the recognition of unrealized gains and losses on AFS securities solely due to interest rate movements – and not actual changes in credit risk – may lead to investor confusion and regulatory capital arbitrage.

The Custody Banks believe that the most sensible policy would be to defer a decision on the removal of the AOCI filter until such time as the final liquidity coverage ratio (the "**LCR**") is determined. The application of a new liquidity framework, particularly the LCR as it was released by the Basel Committee, will compel banks to hold greater stocks of the very high-quality liquid assets that cause AOCI volatility: U.S. government and agency securities and foreign sovereign debt.

If the filter is completely removed systemic risk may actually increase, as certain firms may make liquidity risk management and investment decisions due to accounting methodology differences and not liquidity and interest rate management best practices. For example, as BNY Mellon explained in its July 5 letter to the Agencies, removing the filter may require a bank to hold significantly more capital against a 10-year U.S. Treasury note than a 10-year, fixed-rate, private commercial and industrial loan. This is largely due to a bank instituting a necessary AOCI volatility buffer. Such anomalous results undermine the risk management principles of Basel III, reduce risk sensitivity in capital calculations and will increase systemic and idiosyncratic risk.

If the Agencies are committed to taking action on the AOCI filter before the LCR is finalized, we urge a more judicious and measured approach than complete removal. Given the inherent volatility that would result from removing the AOCI filter and the potential

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6 Question 17 of Regulatory Capital Rules Proposal, 77 FR 52792, 52812 (August 30, 2012).

for unintended consequences, we ask the Agencies to retain the filter for higher quality assets, including all debt securities issued or guaranteed by the United States government, any of its agencies, or government-sponsored entities; certain high-quality foreign sovereign debt; and any instrument that ultimately qualifies for inclusion in the LCR.

Part VII: The application of the asset value correlation factor is not risk-sensitive and inaccurately assumes the same risk profile for all counterparties.

Similar to the Basel III framework, the Advanced Approaches Proposal would require banks, to apply a 1.25 multiplier to the correlation factor used in internal risk-based capital methodologies for wholesale exposures to unregulated financial institutions regardless of size, and for wholesale exposures to regulated financial institutions with total consolidated assets of $100 billion or more.

Given other regulatory developments, particularly those under the Dodd-Frank Act that are aimed at reducing the interconnectedness among financial institutions, the Custody Banks believe that the 1.25 multiplier is not warranted and should be reconsidered. A uniform 1.25 multiplier is an overly blunt tool that fails to take into account specific characteristics of transactions and financial institution counterparties.

The proposed asset value correlation factor applies to wholesale exposures to "financial institutions" – both regulated and unregulated. The Custody Banks believe that the proposed definition of "financial institution" is overly broad. We recommend that the definition be limited to the following entities that are or will be subject to regulatory capital requirements: insured depository institutions (including banks, thrifts and credit unions); depository institution holding companies; nonbank financial companies designated by the Financial Stability Oversight Council under Section 113 of the Dodd-Frank Act; insurance companies; securities firms and holding companies; foreign banks; futures commission merchants; swap dealers and security-based swap dealers; and major swap participants and major security-based swap participants.

Certain entities should be excluded from the definition of "financial institution."[7] If the definition of "financial institution" is revised along the lines suggested, then conforming revisions should be made to the definition of "*regulated* financial institution." Specifically, the term "regulated financial institution" should be revised to include: (1) any U.S.-domiciled "financial institution" (as defined) and (2) any non-U.S. domiciled "financial institution" that is subject to consolidated supervision and regulation comparable to that imposed on a U.S.-domiciled financial institution. This revised definition would allow domestic and international institutions (to the extent that they are captured by the definition of "financial institution") to be considered "*regulated* financial

[7] Specifically, the Custody Banks believe that the following entities should be excluded from the definition of "financial institution": CCPs; regulated exchanges; investment funds, including Volcker Rule covered funds; commodity pools; ERISA plans; and other companies "predominantly engaged" in financial activities.

institutions" if they are regulated in a comparable manner to certain U.S. financial institutions.

Finally, we would also call the Agencies attention to what appears to be a drafting error in the Advanced Approaches Proposal. The final text of the Basel III Accord indicates that the correlation factor for large counterparties and unregulated financial institutions should be $1.25 \text{ X } (0.12 + \mathbf{0.12} \text{x} e^{-50\text{x}PD})$. The Advanced Approaches Proposal sets forth a different formula: $1.25 \text{ X } (0.12 + \mathbf{0.18} \text{x} e^{-50\text{x}PD})$. The impact of this potential error is meaningful, particularly in the context of securities lending. For a standard securities lending transaction, the use of a .18 multiplier may result in a correlation factor that is nearly a third more than an institution would arrive at using final Basel III text.

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Thank you again for the opportunity to comment on matters of concern to the Custody Banks.

Should you have any questions, please feel free to contact Eli K. Peterson, Managing Director and Senior Managing Counsel of The Bank of New York Mellon at 202-624-7925 (e-mail: Eli.Peterson@bnymellon.com); James E. Roselle, Executive Vice President and Associate General Counsel of Northern Trust Corporation at 312-444-7565 (e-mail: jer7@ntrs.com); or Stefan Gavell, Executive Vice-President and Head of Regulatory and Industry Affairs of State Street Corporation at 617-664-8673 (e-mail: smgavell@statestreet.com).

Sincerely,

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