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Office of the Comptroller of the Currency
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Washington, DC 20219
E-mail: regs.comments@occ.treas.gov
Docket IDs: OCC–2012–0008, OCC–2012–0009, OCC–2012–0010

Jennifer J. Johnson, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20051
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Docket Number: R–1442 (RIN 7100–AD87)

Robert E. Feldman, Executive Secretary
Attention: Comments/ Legal ESS
Federal Deposit Insurance Corporation
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RIN Numbers: 3064–AD95, 3064–AD96, 3064–AD97

Notices of Proposed Rulemaking – Regulatory Capital Rules for US Banks

Dear Sir/Madam:

State Street Corporation ("State Street") welcomes the opportunity to comment on the three Notices of Proposed Rulemaking ("NPRs") issued by the Office of the Comptroller of the Currency ("OCC"), the Board of Governors of the Federal Reserve System ("FRB") and the Federal Deposit Insurance Corporation (collectively the "federal banking agencies") to revise and replace capital rules for US banks. In addition to various Basel Committee standards, the NPRs seek to incorporate relevant portions of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"), enacted in July 2010. This includes Section 939A, which requires the removal of all references to credit ratings in US regulation, and Section 171, also known as the 'Collins Amendment', which establishes a capital floor for all US banks via 'generally applicable' capital requirements.

Headquartered in Boston, Massachusetts, State Street specializes in providing institutional investors with investment servicing, investment management and investment research and trading. With $23.4 trillion in assets under custody and administration and $2.1 trillion in assets under management, State Street operates in 29 countries and in more than 100 geographic markets.[1] State Street is organized as a financial holding company, with operations conducted through several entities, primarily its wholly-owned bank subsidiary, State Street Bank and Trust Company. Our perspective in respect of the NPRs is largely informed by our status as a Basel II 'Advanced Approach' bank, our role as one of the world's largest providers of global custody services and as a major investor in securitized assets.

State Street acknowledges the federal banking agencies' efforts to ensure the implementation of various Basel Committee standards, including the Basel III Capital Accord issued in December 2010. We also recognize the challenges faced by the federal banking agencies when seeking to incorporate, within risk-based capital rules, the various legislative requirements of the Dodd-Frank Act. In our view, the introduction of a more robust, consistent and transparent regulatory capital framework can provide important benefits to the US financial system and the broader economy. Still, this requires an approach that is proportionate, that avoids unnecessary disruption, and which reflects the considerable progress made to date by the financial industry in the identification, measurement and management of risk. This includes the introduction of appropriately calibrated risk-based standards and methodologies, broadly informed by both market and industry experience.

As such, we have broad concerns relative to several aspects of the federal banking agencies' intended approach. This is particularly true of measures designed to implement the requirements of the Dodd-Frank Act, which are broadly risk-insensitive and which will require US banks to implement costly new compliance, monitoring and reporting systems. This includes the use of the Simplified Supervisory Formula Approach ("SSFA") for the measurement of exposures to securitized assets, and the imposition on all US banks of a revised general risk-based capital floor. We therefore recommend a series of targeted changes to the NPRs focused on three primary areas of concern: the definition of regulatory capital, the treatment of securities lending and the treatment of securitized assets.

State Street has participated in the development of detailed responses submitted jointly by the financial services trade groups, and we generally support the observations and recommendations included therein. Our intention with this letter is to highlight issues of specific importance to State Street due to our particular custody bank business model.

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[1] As of September 30, 2012.

GENERAL COMMENTS

Implementation Timeline

The federal banking agencies have issued three separate NPRs to revise the regulatory capital framework for US banks, each with its own implementation timeline. The first, the General Approach NPR, addresses risk-based and leverage capital requirements, including minimum ratios and the definition of capital. It is intended to be implemented over a period of six years beginning January 1, 2013, in a manner broadly consistent with the Basel III Capital Accord. The second, the Standardized Approach NPR, introduces new requirements for the calculation of risk-weighted assets for all US banks, including Advanced Approach banks, by virtue of the requirements of the 'Collins Amendment'. It is meant to be applicable as of January 1, 2015. The third, the Advanced Approach NPR, addresses the calculation of risk-weighted assets by the largest, most complex US banks. While the Advanced Approach NPR does not include a formal implementation date, it is widely understood that the proposed changes are intended to be introduced in conjunction with the publication of a Final Rule, presumably in 2013.

In effect then, and notwithstanding the goal of codifying a uniform regulatory capital framework, US banks face the prospect of compliance with a complex and disparate set of standards, introduced in a piecemeal fashion over a period of several years. This is further complicated by the ongoing Basel II qualification process, the broad interdependencies which exist between core aspects of the Standardized and Advanced Approaches, and the lack of rules relative to the implementation in the US of a capital surcharge for systemically important financial institutions. In our view, this is likely to greatly complicate industry compliance and also cause significant market uncertainty. Indeed, US banks will be compelled to make and explain a series of broad assumptions relative to their risk-based capital, and to operate over a lengthy period of time on the basis of easily misunderstood hybrid standards. This includes having to explain the impact and timing of the rules to the market, notably to analysts and investors, where there are growing expectations for a simple, fully-implemented view of regulatory capital ratios.

The changes proposed by the federal banking agencies to existing risk-based capital regulations are substantial and will inevitably have far-reaching operational implications for a bank's global treasury, corporate finance, risk management, compliance and other internal control functions, as well as core lines of business. This includes far more granular data capture and reporting requirements and the ability to aggregate information across multiple platforms and systems. Among the most significant sources of additional complexity in the proposed NPRs are the data requirements of the SSFA, the broad definition of a potential securitization exposure, and the expansive definition of a financial institution. We also note the considerable complexity inherent in proposed rules that would fundamentally change the methodologies used by US banks in the assessment of their exposures to repurchase-style transactions, including securities lending transactions. As a result, compliance with the revised capital rules will be complex, costly and time consuming, and present significant industry-wide challenges.

In order to address these concerns, we strongly urge the federal banking agencies to provide the industry with an appropriately lengthy implementation timeframe, and to introduce changes to the Advanced and Standardized Approaches on a uniform basis. This is particularly necessary in view of the 'Collins Amendment', which unlike the international Basel standards, requires the largest, most complex US banks to calculate risk-based capital on the basis of both the Standardized and Advanced Approaches. In our view, an appropriate timeframe for the introduction of changes to both the Standardized and Advanced Approaches is January 1, 2015, the date currently specified in the Basel NPRs for the implementation of the revised Standardized Approach.

Calculation Criteria

State Street emphasizes its strong support for the position taken by the federal banking agencies in the General Approach NPR that Advanced Approach banks should calculate their capital buffers, including the capital conservation buffer, on the basis of the Advanced Approach framework. Notwithstanding legislative intent, we believe that the introduction via the Collins Amendment of a 'generally applicable' capital floor for all US banks is deeply problematic since it undermines the fundamental premise of the Advanced Approach framework, may create powerful disincentives for US banks to improve their overall assessment and management of risk, and is likely to lead to broad competitive disparities relative to banks that are subject to the international Basel standards. We also note the significant multi-million dollar investments that the financial industry has made under the Advanced Approach framework to enhance risk management processes, as well as capital management systems and controls, expenditures which may no longer prove justified. We therefore strongly support reasonable steps to mitigate the impact of the Collins Amendment, including via the careful tailoring of the scope of the 'generally applicable' capital requirement to align with prompt corrective action standards.

Similarly, we also request confirmation from the federal banking agencies relative to our understanding that the required calculation of 'generally applicable' capital requirements by Advanced Approach banks is intended to apply at the level of the consolidated entity. We view this approach as consistent with legislative statute, and also note its importance in further addressing the limitations of the Collins Amendment, as described in the previous paragraph.

Under the proposed Standardized Approach and Advanced Approach NPRs, US banks would be required in several instances to calculate their regulatory capital on the basis of a 1,250% risk-weight. This includes exposures to certain unsettled transactions, default fund exposures to non-qualifying central clearinghouses ("CCPs"), and most importantly securitization-related exposures, with the 1,250% risk-weight serving as the default requirement in the event that a bank is unable to make use of either the Supervisory Formula Approach ("SFA") or the SSFA. While we recognize the federal banking agencies' goal of converting certain dollar-for-dollar capital charges into a risk-weighted equivalent, we are concerned that the intended approach penalizes well-capitalized banks that hold risk-based capital in excess of the original Basel I minimum (*i.e.* 8%). Indeed, while a 1250% risk-weight is equivalent to a dollar-for-dollar capital charge for a bank with an 8% capital ratio, for a well-capitalized bank with a capital ratio of 12%, the risk-weight equivalent to a dollar-for-dollar capital charge is 833%.

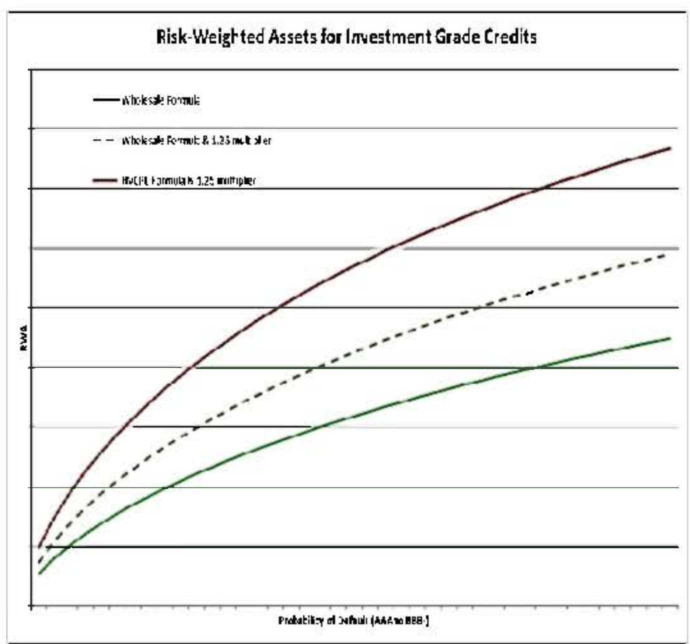
In order to address this suboptimal outcome, we urge the federal banking agencies to allow US banks to calculate an institution-specific dollar-for-dollar equivalent risk-weight charge, in a manner consistent with the 'direct reduction method' used in the context of FFIEC Schedule RC-R.[2] Under this approach, banks would be permitted to reflect in their risk-based capital calculations their actual regulatory capital ratios, and would not be required to hold more capital than an underlying exposure's carrying value. As such, the disproportionate treatment of well-capitalized banks under the intended regulatory capital framework would be addressed.

Asset Value Correlation Factor

Under the proposed Advanced Approach NPR, US banks will be required to apply a multiplier (*i.e.* 1.25) to the correlation formula for wholesale exposures to all unregulated financial institutions and wholesale exposures to regulated financial institutions with total consolidated assets in excess of $100 billion (*i.e.* "covered wholesale exposures"). The definition of a financial institution is specified in the General Approach NPR and incorporates a broad range of entities, including investment funds. The purpose of the multiplier, the Asset Value Correlation ("AVC") factor, is to further address the perceived correlation of risk among entities in the financial system and to help mitigate interconnectedness. In the preamble to the Advanced Approach NPR, the federal banking agencies specify their intention to introduce the AVC factor in a manner consistent with international Basel standards.

For the purposes of the Basel III quantitative impact study, the Bank for International Settlements specifies the use, as per the prevailing international Basel II accord, of the following formula for covered wholesale exposures: $R = 1.25 \times (0.12 + 0.12e^{-50xPD})$. This is consistent with the US version of the Basel II rules, where a distinction is drawn in the correlation formula between HVCRE and non-HVCRE exposures. Specifically, HVCRE exposures are calculated on the basis of $R = 0.12 + 0.18e^{-50xPD}$ and non-HVCRE exposures are calculated on the basis of $R = 0.12 + 0.12e^{-50xPD}$. In Table 1 of the Advanced Approach NPR, however, the federal banking agencies specify a different formula for covered wholesale exposures, namely $R = 1.25 \times (0.12 + 0.18e^{-50xPD})$. This incorporates

Figure 1: Impact of AVC on RWA



[2] Federal Financial Institution Examination Council Schedule RC-R – Regulatory Capital

the formula used for HVCRE exposures (*i.e.* $0.12 + 0.18e^{-50xPD}$), and therefore produces a significantly elevated risk weight when applied to covered wholesale exposures.

Using the existing formula for wholesale exposures with the proposed AVC factor (*i.e.* 1.25) results in an increased risk-weighting for covered wholesale exposures of between 32% and 36%, depending upon the probability of default of the obligor *(i.e.* the difference between the bottom green solid line and the middle green dashed line in Figure 1). Using the formula for HVCRE exposures, however, results in an increased risk weight for covered wholesale exposures of between 71% and 87% *(i.e.* the difference between the top solid red line and the bottom solid green line in Figure 1). Both of these outcomes are significant and have been proposed without any particular empirical support.

Since there is no mention in the preamble of this formula change and no clear rationale for its introduction, we believe that this may simply represent a drafting error. Still, given its fundamental importance in the calculation of overall risk-based capital, we urge the federal banking agencies to clarify that the correct AVC factor formula for covered wholesale exposures is $R = 1.25 \times (0.12 + 0.12e^{-50xPD})$.

DEFINITION OF REGULATORY CAPITAL

Treatment of Unrealized Gains/ Losses

The federal banking agencies propose in the General Approach NPR to eliminate the existing filter on unrealized gains and losses on available for sale ("AFS") securities from regulatory capital. This would be implemented on a phased basis beginning in 2014 over a period of four years. In recognition, however, of the possible adverse consequences of this approach, the federal banking agencies seek comment on an alternative filter that would permit banks to exclude unrealized gains and losses on AFS securities resulting from interest rate movements. More specifically, the federal banking agencies are considering the exclusion of unrealized gains and losses on US government and agency debt obligations, US government sponsored enterprise ("GSE") debt obligations, other sovereign obligations that qualify for a zero percent risk-weight under the revised Standardized Approach, and perhaps US state and municipal obligations.

Custody banks such as State Street have balance sheets that are constructed differently than those of other, more traditional commercial banks. Custody bank balance sheets are built around client deposits derived from the provision of core custody and fund administration services to institutional investor clients. These deposits represent a stable source of long-term funding whose value is monetized by custody banks via the purchase of large and well-diversified portfolios of high-quality investment assets. Unlike more traditional commercial banks, custody banks make few loans and are therefore unable to broadly benefit from the held-to-maturity ("HTM") treatment that applies to loan assets. As such and notwithstanding their more conservative risk-profile, custody banks will be disproportionately affected by changes in the regulatory capital treatment of AFS securities when compared with other, more traditional commercial banks. In our view, this disparate treatment is a matter of significant concern that bears careful regulatory consideration.

As an initial matter, we strongly recommend that the existing regulatory capital treatment for unrealized gains and losses on AFS securities be retained. US banks are already required to hold Pillar I capital for their AFS securities to reflect credit risk and Pillar II capital to reflect net interest rate risk. As such, the proposed removal of the prevailing filter for unrealized gains and losses on AFS securities would lead to the potentially significant 'double counting' of capital. This is particularly true in a rising interest rate environment or during periods of financial stress, where mark-to-market losses can be substantial and can broadly diverge from the actual performance of the underlying asset. Conversely, in a period of falling interest rates and/or a narrowing of asset spreads, bank capital levels will increase, possibly resulting in capital ratios that are deceptively robust. The suggested elimination of the current treatment for unrealized gains and losses on AFS securities is therefore highly pro-cyclical, resulting in substantial capital volatility at precisely the wrong time in the interest rate cycle or crisis event.

As a matter of practice, State Street generally does not raise capital to cover unrealized losses, nor does it seek to buy back common shares on the basis of unrealized gains. This reflects our understanding of the inherent volatility of mark-to-market pricing, including the potential for rapid reversals. AFS securities are an important tool for banks when undertaking asset and liability management ("ALM") strategies, including in respect of both interest rate and liquidity risk. In our view, it would be suboptimal if banks were discouraged from the efficient and prudent use of ALM strategies in order to address accounting-driven concerns. This includes the potential for broader reliance by US banks on less flexible HTM assets. To mitigate the effects of this volatility, banks will have to hold significant amounts of capital above their already substantially increased core ratios to serve as a buffer against changes in market value, thereby further increasing the cost of capital for even the highest quality investment assets.

Furthermore, the removal of the filter for unrealized gains and losses on AFS securities will force banks to significantly shorten the duration and maturity of their investment portfolios. This has broad negative implications for various longer-dated assets that help support important segments of the economy, including agency mortgage-backed securities, other high-quality asset-backed securities, such as credit card and automobile receivables, and municipal obligations, because banks are buyers of a significant amount of these assets. In addition, the intended approach incorrectly adopts a 'liquidation' view of capital, as opposed to a more appropriate 'going concern' assessment. We note, in this respect, that banks are unlikely to sell off assets in a funding or economic crisis, preferring instead to use these assets as collateral to obtain secured funding, including via the FRB discount window. Concerns relative to the existence of sufficient amounts of high-quality liquid assets available for use as collateral have been broadly addressed via the Basel III Liquidity Accord, scheduled for implementation as a minimum standard as of January 1, 2015.

If the federal banking agencies nonetheless conclude that the existing regulatory capital treatment for unrealized gains and losses on AFS securities must be adjusted, we strongly support the proposed introduction of an alternative filter designed to address the impact of valuation changes that primarily relate to variations in interest rates. In our view, this new filter should be defined as expansively as possible to include all debt securities whose changes in market value can primarily be ascribed to interest-rate fluctuations, such as US government and agency debt, agency and GSE mortgage-backed securities, sovereign and supra-national exposures with a zero-percent risk weight under the proposed OECD Country Risk Classification ("CRC") scheme, and high-quality US municipal general obligation and revenue bonds.

In addition, we recommend that the revised filter exclude from regulatory capital, all unrealized gains and losses on AFS securities that meet the criteria for inclusion in the proposed Dodd-Frank Act Section 165 buffer of high-quality liquidity assets. Generally, it would be beneficial to consider the use of a revised filter for unrealized gains and losses on AFS securities in conjunction with the definition of high-quality liquid assets as adopted in the US. This includes the still to be finalized Basel III Liquidity Coverage Ratio. It may therefore be advisable for the federal banking agencies to delay changes to the existing treatment of unrealized gains and losses on AFS securities until after publication of final liquidity rules.

Unconsolidated Financial Institutions

Consistent with the Basel III Capital Accord, the federal banking agencies propose in the General Approach NPR the deduction from regulatory capital of investments held by US banks in the securities of unconsolidated financial institutions. This includes both significant and non-significant investments, defined on the basis of whether the bank owns more or less than 10% of the issued and outstanding common shares of an unconsolidated financial institution. While we acknowledge concerns relative to interconnections within the financial industry, we note as an initial matter that the federal banking agencies are already seeking to address this concern via a number of regulatory initiatives. This includes the enhanced prudential standards and early remediation requirements that apply to banks with total consolidated assets in excess of $50 billion and other financial entities designated as systemically important pursuant to Section 165 and 166 of the Dodd-Frank Act. This also includes the use of an AVC factor multiplier (1.25) in the Advanced Approach NPR for certain financial institution exposures, specifically those to any unregulated financial institution and those to regulated financial institutions with total consolidated assets in excess of $100 billion.

Moreover, we note that the intended definition of a financial institution in the General Approach NPR is extremely broad, covering bank and bank holding companies, insurance companies, securities firms and securities holding companies, commodity pools, Volcker Rule covered funds, ERISA plans and any other company 'predominantly engaged' in financial activities. In comparison, the international Basel standards address investments in the capital of 'banking, financial and insurance entities.' The 'other company' standard is particularly problematic since it will require US banks to invest significant resources in order to assess the assets and revenues of a broad range of entities, some of which may not be publicly or readily accessible. As such, the proposed definition will require major investments by banks in information technology systems to capture, aggregate and assess the required information. This includes exposures to investment funds which have historically been subject to treatment under risk-based capital rules as equity exposures.

In order to reduce unnecessary operational complexity, we recommend that the intended definition of a financial institution be narrowed so as to exclude investment funds regulated under the Investment Company Act of 1940 ("40 Act funds") and their foreign equivalents, such as European Union ("EU") Undertakings for Collective Investment in Transferable Securities. While we concede that this approach may result in certain de facto investments in a financial institution, such as an individual component of the S&P 500, we believe that these exposure amounts are minimal relative to other areas of regulatory concern and that they are broadly addressed by the transparency and diversification requirements that apply to publicly issued funds.

Exposures to such investment funds would still be subject to treatment under the US regulatory capital framework as equity exposures, on the basis of the simple modified look-through, the alternative modified look-through or the full-look through approach. In view, however, of the virtual impossibility of obtaining the data required to assess securitization exposures that may be held in such funds using the prescribed SFA or SSFA methodologies, we recommend that the federal banking agencies permit the use by US banks of an equivalent to the Basel II simple risk-weight approach for non-investment fund exposures. Under this alternative, US banks would be permitted to apply to their otherwise excluded investment fund exposures, a uniform default risk-weight of 600%. We note, in this respect, that any concerns relative to the particular treatment of equity exposures by a US bank can be addressed via the existing supervisory review process as appropriate.

SECURITIES LENDING

Use of Simple VaR

Under the proposed Standardized Approach NPR, US banks would no longer be permitted to use supervisory-approved value-at-risk (VaR) models when calculating their exposure to repurchase-style transactions, including securities lending transactions. As an alternative, US banks would be required to use either the simple collateral approach or the collateral haircut approach, with the former based upon standard supervisory haircuts or, with supervisory approval, an own estimate of haircuts. Due to the requirements of Section 171 of the Dodd-Frank Act, this proposed treatment would also apply to US banks subject to the Advanced Approach when calculating their 'generally applicable' risk-based capital requirements.

In view, however, of the prevailing international Basel II standards, the federal banking agencies request comment on whether they should reverse their position and continue to allow the use of simple VaR methodologies in the US implementation of the Standardized Approach for exposures to repurchase-style transactions, including securities lending transactions. Consistent with the custody banking industry as a whole, State Street strongly supports this alternative treatment.

As widely recognized by many within the regulatory community, securities lending is critical to the efficient functioning of global financial markets. Securities lending helps facilitate the timely settlement of market transactions, as well as the conduct of both market making and hedging activities. Securities lending helps increase market liquidity and enhances the overall price-discovery process by supporting short selling and other strategic and tactical asset allocation strategies. In addition, securities lending provides important benefits to institutional investors, such as pension plans and mutual funds, by enabling investors to generate low-risk, incremental returns on their investment portfolio, used to enhance performance and offset administrative and other costs.

Custody banks, such as State Street, have long provided agency securities lending services to their institutional investor clients under the supervision of prudential regulators. The securities lending market is characterized by and subject to well-developed risk controls. This includes the over-collateralization of all securities loans with cash or other high-quality assets, the daily marking of all positions to market, and the re-margining of loans as required to ensure ongoing over-collateralization. Custody banks also often provide an additional layer of protection to their institutional investor clients by indemnifying exposures in excess of the value of the collateral received in the event of borrower default. Credit exposures resulting from securities lending activities are subject to prudential oversight and are reflected in existing risk-based capital requirements. This includes indemnification risk, which in the event of default would be realized via a corresponding reduction in capital. Although important to the overall structure of the market, the risk of client indemnification is quite limited, with custody banks having rarely experienced more than *de minimus* securities lending-related losses.

Banks that are active in the securities lending market, including custody banks with large agency lending programs, typically use VaR methodologies when calculating their counterparty credit exposures. These models, which State Street has used in various capacities since the mid-1990s, have evolved as banks and supervisors have developed expertise, including on the basis of ongoing, detailed regulatory scrutiny. They have also benefitted from significant multi-million dollar investments and systems upgrades. Under the proposed Standardized Approach NPR, US banks would be required to abandon these well-established, supervisory-approved methodologies in favor of a rigid and excessively conservative haircut based-approach that would significantly overstate actual credit risk. This would, in turn, likely result in a dramatic and unwarranted contraction of the securities lending market, with important negative externalities for both financial markets and investors.

Unlike the collateral haircut approach, VaR methodologies possess several features that make them particularly well-suited to measuring counterparty credit exposure in securities lending transactions. This includes appropriate, market-driven data inputs that reflect, among others, the short duration of most securities loans. In addition, VaR methodologies appropriately capture and recognize the correlation effect between securities lent and collateral received. This is particularly critical in the case of non-US markets, where the prudent use of equities and other non-cash collateral is common. As such, VaR methodologies serve as a far more accurate measure of risk than the collateral haircut approach envisioned by the federal banking agencies. This is validated by the back-testing conducted by banks over the course of the past several years, with VaR methodologies demonstrating appropriate risk-sensitivity.

Given its lack of recognition for the correlation benefits in securities lending transactions, the proposed collateral haircut approach is likely to encourage greater industry reliance on cash collateral. This will, in turn, result in greater levels of maturity transformation via the cash collateral reinvestment process. Moreover, because of the likely impact of new liquidity standards on the issuance of short-term debt, cash collateral may require reinvestment in longer-dated, less liquid instruments with higher levels of potential credit risk. Greater use of cash collateral may also result in broader market dislocation during periods of financial stress due to higher liquidity demands faced by financial institutions. These concerns have been raised by among others, the Financial Stability Board's Workstream on Securities Lending and Repo in an Interim Report dated April 21, 2012.

State Street therefore strongly urges the federal banking agencies to reverse their initial position and continue to allow the use of supervisory-approved simple VaR methodologies in the US implementation of the Standardized Approach for exposures to repurchase-style transactions, including securities lending transactions. In addition to ensuring a more accurate assessment of counterparty credit risk, this approach will reduce costly and potentially disruptive changes in prevailing risk management practices, while also avoiding unnecessary financial market dislocation. Furthermore, this approach would better align US capital rules with the Basel standards in other jurisdictions, notably the EU, where banks are permitted to use models-based approaches in the calculation of their exposure to securities lending transactions, thereby avoiding the emergence of broad competitive inequities that could shift the business away from US banks.

While the continued ability of US banks to use existing simple VaR models to assess their exposures to securities lending transactions represents, in our view, the most effective way forward, it is possible for the federal banking agencies to develop an alternative approach that provides for greater methodological standardization. For example, the federal banking agencies could permit the continued use of simple VaR under the Standardized Approach, but with a series of supervisory inputs designed to reflect observable market data, as well as measures of volatility and asset correlation. Although less risk-sensitive than prevailing supervisory approved VaR models, this would address the regulatory objective of a more consistent industry measure of risk, while avoiding the dramatic overstatement of exposures inherent in the collateral haircut-based alternative.

Holding Period for Netting Sets in Collateralized Transactions

The federal banking agencies' Standardized Approach and Advanced Approach NPRs incorporate the use of a 20 business-day holding period for collateral in certain netting sets, including those with more than 5,000 transactions at any time during a given quarter, with the exception of netting sets involving CCPs. This contrasts with the 5 business-day holding period currently permitted for securities lending and repurchase transactions.

As an initial matter, we question whether the size of the netting set is an effective proxy for risk. This is especially true in the context of securities lending activities, where large transaction volumes are common, where banks have significant experience managing counterparty risk and where the financial crisis revealed no meaningful operational limitations. In our view, liquidity is primarily a function of the collateral asset class and the position's size relative to transacted volumes. As such, collateral liquidity can effectively be controlled via other measures, including prudent concentration, duration and market volume limits in agency lending programs, as well as appropriate market-based haircuts.

When combined with the proposed collateral haircut approach and the treatment of netting sets with more than two margin disputes in a two quarter period, restrictions on larger netting sets may actually create a disincentive for agent lenders to apply best practices, such as the diversification of loans among several counterparties. This is because agent lenders would face a less onerous capital treatment by executing large transactions with a single counterparty than by diversifying their exposure across multiple entities, an alternative that would both increase the raw number transactions and the possibility for margin disputes. Moreover, the proposed treatment of margin disputes would likely serve to suppress the routine review of cash discrepancies as counterparties seek to avoid a potentially sharp increase in risk-based capital, thereby enhancing rather than reducing margin-related risk.

We therefore urge the federal banking agencies to remove the size of the netting set as a factor in the required adoption of a longer collateral holding period. If the federal banking agencies nonetheless decide to retain the 5,000 netting set threshold, we urge as an initial matter, clarification regarding the intended definition of the term 'transaction'. More specifically, we believe that 'transaction' should be defined on the basis of market-facing transactions, rather than on the basis of the allocation of trades among an agent lender's clients. This is, in our view, consistent with potential market-risk concerns, and also serves to avoid unwarranted disruptions in agency lending practices.

Similarly, in order to ensure greater regulatory proportionality, we urge the federal baking agencies to revise the manner in which the 5,000 netting set threshold is to be calculated. More specifically, we recommend calculation on a quarterly average basis rather than on the basis of any breach of the 5,000 netting set threshold in a given quarter. In the case of margin disputes in a netting set, we recommend the introduction of a materiality threshold which would only require the imposition of a holding period that is at least twice the minimum existing holding period, in situations where the margin dispute creates an exposure to the agent lender that exceeds available over-collateralization.

Financial Institution Counterparties

The federal banking agencies' Standardized Approach NPR deviates from the international Basel framework by proposing to re-categorize US bank exposures to securities firms as corporate exposures. As a result, exposures to securities firms would be subject to a uniform 100% risk-weight, as opposed to the 20% risk-weight that would otherwise apply to qualifying securities firms. While we recognize the regulatory impetus behind this approach, we believe that it would be appropriate for the Standardized Approach to reflect a distinction in the risk profile of bank-affiliated securities firms as opposed to non-bank affiliated securities firms. This reflects the prudential supervision that governs bank-affiliated securities firms, including regulatory capital requirements and robust risk management standards. More specifically, we urge that bank-affiliated securities firms in jurisdictions with an OECD CRC rating of 0 or 1 should receive a 20% risk-weight.

Supplementary Leverage Ratio

The federal banking agencies propose in the General Approach NPR to maintain the current on-balance sheet measurement of repurchase-style transactions by US banks, including securities lending transactions, for the purposes of the supplementary leverage ratio. State Street strongly supports this position, and recommends that this treatment be preserved for the reporting of the supplemental leverage ratio by Advanced Approach banks beginning January 1, 2015.

In our view, any calculation of securities lending transactions involving notional exposure would seriously overstate the economic risk inherent in these activities, dramatically expand the size of custodian bank balance sheets in a highly misleading manner, and also significantly undermine the ability of custody banks to support essential market liquidity. As noted in our earlier comments, custody banks undertake securities lending transactions on an agency-indemnified basis on behalf of their institutional investor clients. These transactions are not designed to create leverage on the custodian bank's balance sheet, with borrowed assets transferred to the counterparty versus appropriate collateral.

The overwhelming majority of agent bank counterparties in the securities lending market are other banks or bank-affiliated securities firms, subject to both prudential supervision and regulatory capital requirements. Moreover, the leverage that agent bank counterparties may create via the borrowing of securities is already reflected in their respective balance sheets. To therefore require agent banks to do the same would effectively lead to the massive double-counting of exposures within the global banking system. Agent bank exposure to potential indemnification risk in securities lending transactions is already appropriately captured in the calculation of risk-based capital. In the event of default, any loss (*i.e.* where collateral is insufficient to make institutional investor clients whole) would be realized via a corresponding reduction in capital, and would have no impact on balance sheet assets.

SECURITIZED ASSETS

Definition of a Securitization

In each of the Basel NPRs, the federal banking agencies seek to clarify the prevailing regulatory definition of a traditional securitization. More specifically, the federal banking agencies propose to exclude from the definition certain types of investment fund exposures, including exposures to pension funds regulated under the Employee Retirement Income Security Act ("ERISA") and their foreign equivalents, and exposures to mutual funds regulated under the 40 Act and their foreign equivalents. In view of the extensive debate generated by initial guidance from the federal banking agencies relative to the need to treat every exposure to an investment fund as a potential securitization exposure, this is a welcome development which we strongly support.

We are nevertheless concerned that the intended definition still encompasses a large number of investment fund exposures that are not securitizations, and that US banks will therefore be required to implement an unnecessarily expansive, onerous and time consuming internal validation process. Moreover, we are concerned that the intended approach does not provide US banks with the necessary regulatory certainty to understand the scope of their investment fund exposures potentially subject to treatment as securitization exposures. While we understand that the federal banking agencies intend to provide additional guidance relative to this matter, this will not occur prior to the end of the Basel NPRs' comment period, thereby limiting the industry's ability to assess the suitability and fairness of the intended approach. It may therefore be advisable for the federal banking agencies to further consider the proper scope of investment fund exposures subject to treatment as a securitization exposure, via a separate round of rulemaking.

As an initial technical matter, we recommend that the proposed definition of an excluded investment fund exposure be expanded to incorporate state and other US public pension funds and benefit plans. This would include, for instance, pension funds and benefit plans governed by Section 178a of the New York State Retirement and Social Security Act and those governed by the State of Illinois Pension Code 40 ILCS5. Notwithstanding their different underlying legal construct, state pension funds and benefit plans are functionally and structurally similar to ERISA plans, serving as regulated vehicles for the accumulation by employees of retirement income and other similar benefits (*e.g.* health and welfare benefits). Moreover, these plans are subject to the same fundamental duty of protection and fiduciary responsibility. An adjustment to the intended definition of excluded investment fund exposures to include state and other US public pension funds and benefit plans should therefore be non-controversial.

Under the intended hierarchy of approaches in the Basel NPRs, banks that cannot use either the SFA or the SSFA to determine their risk exposure to a securitized asset are required to apply a default risk-weight of 1,250%. This could prove extremely problematic for many types of investment fund exposures, since banks will not realistically be able to obtain the information required to calculate their exposures under either methodology. This includes core SSFA parameters, such as Kg (the weighted-average total capital requirement of the underlying exposures), attachment point and detachment point. In effect then, there is a strong risk of a significant disconnect between the treatment of an investment fund as a securitization exposure and the hierarchy of approaches available to US banks to measure these exposures.

While we understand the federal banking agencies' concerns with the risks presented by securitization exposures generally, we believe that it would be appropriate for the definition of a traditional securitization to also incorporate an exemption for certain types of well-established banking activities. As an example, from our perspective as a global custodian, we strongly recommend that routine extensions of credit provided to investment funds to support day-to-day investment-related activities should benefit from such an exclusion. This includes overnight advances to address unanticipated investment activities, such as client redemptions or the payment of investment fees and other expenses, intra-day or overnight advances to accommodate timing differences in payment or securities settlement systems, contractual settlement credits based upon expected trade settlement activities, and contractual income payments based upon the expected receipt of issuer income.

These exposures are essential to the smooth operation of payment and securities settlement systems globally, and bear no resemblance to the classic form of a securitization. They are typically limited in duration and scope, are governed by specific custody documentation or other similar agreements, and are generally collateralized by the investment fund's assets. Moreover, there is no tranching of risk with respect to these exposures, whether the investment fund is regulated or unregulated, and no transfer of risks occurs to the custody bank when providing such services. Unlike in a true securitization, the repayment of these credit extensions are not linked to income or cash flow generated by the investment fund's assets, but rather by the independent capacity of the fund as a commercial entity. Finally, we note that these routine investment fund exposures do not in any conceivable way equate to an investment by the custody bank in the impacted fund.

More broadly, we urge the federal banking agencies to recognize and address the considerable difficulties that US banks will face if compelled to assess their exposures to an investment fund on the basis of the methodologies prescribed in the Basel NPRs for securitized assets. This includes the potential for the frequent and unwarranted imposition of an onerous default risk-weight charge of 1,250%. In our view, this suggests the need for an alternative risk-based methodology that better reflects the nature of the target exposures and which incorporates more graduated risk-weights.

Simplified Supervisory Formula Approach – Data Elements

Consistent with the requirements of Section 939A of the Dodd-Frank Act, the federal banking agencies introduce in the Standardized and Advanced Approach NPRs a new methodology for assigning risk-weights to securitized assets that does not rely on credit ratings. This methodology, the SSFA, is also found in the Market Risk Rule, which is effective for certain banks with significant trading activities as of January 1, 2013. We note, in this respect, that State Street submitted comments on the proposed 'Alternatives to Credit Ratings for Debt and Securitization Positions in the Market Risk Rules' that address concerns relative to both the structure and calibration of the SSFA.[3]

While we appreciate the federal banking agencies' efforts to develop alternative measures of creditworthiness that do not rely on credit ratings, we remain concerned that the SSFA lacks sufficient risk-sensitivity and is therefore likely to significantly overstate the amount of capital that banks must hold to support securitized assets. This includes the introduction of a minimum risk-weight floor of 20% for even the most senior, highest-rated exposures, or almost three times the prevailing international Basel II floor of 7%. Our concerns in respect of the SSFA reflect our status as a major investor in securitized assets rather than as an originator. In common with other custody banks, State Street does not engage in substantial lending activities, but instead holds a sizable portfolio of diversified, high-quality investment securities funded by significant amounts of long-term stable, client deposits.

We therefore have an interest in ensuring the proper underwriting and full disclosure of information relative to securitized assets. Still, we believe that US banks should not be penalized for their prudent use of investment portfolios, and that the intended regulatory framework should draw appropriate distinctions between investors and originators in these assets. This includes the ability to access required data inputs. We therefore recommend a series of targeted adjustments to the SSFA, designed to better reflect data availability and improve risk sensitivity without undermining core policy intent.

In order to promote good underwriting practices and account for varying levels of credit risk, the federal banking agencies propose to divide residential mortgage exposures that are not guaranteed by the US government or a GSE into two categories. Category 1 is comprised of high-quality residential mortgage exposures and is assigned a minimum standardized risk-weight of 35%. There are eight specific requirements that must be met for treatment as a Category 1 exposure, addressing among others, mortgage loan terms, the standards used in the underwriting process, the seniority of the mortgage exposure and delinquency rates. Category 2 is comprised of residential mortgage exposures that do not meet the criteria for inclusion in Category 1 and is assigned a minimum standardized risk-weight of 100%.

While we support the broad outlines of this approach, we note that the intended data inputs are substantial, requiring investors in residential mortgage-backed securities ("RMBS") to obtain detailed information relative to underwriting standards and loan to value ratios ("LTV") at the level of each residential mortgage exposure. In addition, investors must continuously monitor a series of variable criteria, such as the presence of loan modifications, secondary mortgages and delinquencies. Indeed, certain of these inputs are not currently available in the

[3] Comment letter is dated February 3, 2012.

market and would be exceptionally difficult if not impossible for investors to otherwise obtain. This is especially true in the case of debt-to-income ratio at origination, a metric that does not even benefit from consistent industry treatment.

While it is not unreasonable to expect that the US residential mortgage market will over time evolve to meet the standards prescribed in the SSFA, this is not the case for legacy RMBS issued prior to the Basel NPRs, where data problems will invariably persist. The size of the existing non-agency US RMBS market is material and currently estimated at $1 trillion. In addition, it is unclear whether foreign RMBS will ever conform to the US-centric requirements of the SSFA. This reflects, among other things, the existence of different national underwriting standards, different market expectations relative to loan-level data, and the inapplicability of the SSFA methodology outside of the US. As a result, investors may be forced to default to Category 2 treatment and the higher 100% minimum standardized risk-weight for much of their US and non-US RMBS portfolios, irrespective of the performance and quality of the underlying mortgage loans.

In order to address these pressing concerns, we strongly recommend as an initial matter, the grand-fathering of all RMBS originated prior to issuance of a Final Rule for the later of the Advanced Approach or Standardized Approach NPRs. More specifically, US banks should be permitted for legacy RMBS, to use existing general risk-based capital rules to determine Kg for the purposes of the SSFA. This includes a standardized 50% risk-weight for RMBS that meet the prescribed 'prudently underwritten' standards and a standardized 100% risk-weight for all other RMBS. Other components of the SSFA, including attachment and detachment points and cumulative losses would remain unchanged. As such, grand-fathering would be permitted in order to address specific data limitations in legacy RMBS, and would not enable banks to broadly or indefinitely bypass the overall securitization framework. We note, in this respect, that the industry standard being developed by Bloomberg for purposes of compliance with the Market Risk Rule is based upon this same methodology.

While we believe that this approach can reasonably address data limitations in legacy RMBS, as previously emphasized we are concerned that the SSFA is not well-suited to foreign RMBS generally, making a series of assumptions relative to the quality of residential mortgage exposures that may not be appropriate in other national jurisdictions. As an example, Dutch mortgage loans, which are widely viewed as among the strongest in the European market, are characterized by high LTVs and interest-only features due to tax deductibility incentives. These features would disproportionately penalize Dutch mortgage loans in the context of the SSFA, even though they are underwritten to very stringent debt to income standards (not more than one third of gross income), have very low delinquency rates and benefit from national bankruptcy laws that prevent discharge of the mortgage loan obligation. Also, in view of the inapplicability of the SSFA outside of the US, there are significant concerns as to whether investors in foreign RMBS can reasonably be expected to meet the prescribed data requirements for Category 1 designation. This includes, in particular, demonstration that the underlying loans are underwritten based on verified income and on the basis of the borrower's full mortgage obligation.

In order to address these concerns, we recommend the continued use for foreign RMBS of the 'prudently underwritten' framework contained in prevailing general risk-based capital rules. More specifically, US banks would be permitted to determine the eligibility of a foreign RMBS for treatment as a Category 1 exposure based on its ability to demonstrate that the underlying loans were originated in a manner consistent with the particular national jurisdiction's understanding of a 'prudently underwritten' loan. Additionally, the federal banking agencies could require the foreign RMBS to be originated by entities subject to prudential supervision in national jurisdictions with an OECD CRC rating of 0-1. Per the proposed Category 1 criteria, US banks would always be required to ensure that the underlying foreign loans do not represent junior-lien exposures and that they are not in past due or non-accrual status.

Simplified Supervisory Formula Approach – Private Mortgage Insurance

Under the Basel NPRs, US banks would no longer be permitted to recognize private mortgage insurance ("PMI") when calculating LTV on a residential mortgage exposure, including for the purposes of the SSFA. While we acknowledge the concerns which have been raised relative to the financial strength of certain PMI providers, primarily mono-line bond insurers, we believe that this approach is overly rigid, including in respect of insurance that may be available outside of the US. As an example, Australian RMBS routinely include 'Lenders Mortgage Insurance' ("LMI") provided by entities subject to prudential regulation by the Australian Prudential Regulatory Authority. These regulations include strict capital and reporting requirements, consolidated entity supervision, and stringent mortgage underwriting criteria, measures which are likely to reduce the correlation of LMI performance with that of the Australian housing market generally. Indeed, Australian LMI has demonstrated considerable resilience and is widely acknowledged as an essential credit enhancement, with Australian banks holding higher-LTV mortgages backed by LMI subject in their national jurisdiction to a lower 50% rather than a 100% risk-weight charge.

State Street therefore recommends that the federal banking agencies amend the Standardized Approach NPR to allow recognition of PMI/ LMI provided by 'financially sound' entities, in the calculation of LTV. More specifically, the federal banking agencies may wish to introduce an 'investment grade' standard similar to that which prevails in OCC guidance relative to investment securities, in which a US bank would need to demonstrate that the insurer has 'adequate capacity' to meet its financial commitments for the projected life of the residential mortgage exposure. This would include an assessment of whether the risk of default by the PMI/ LMI provider is low and whether full and timely repayment can be expected in the event of a default. In addition, the federal banking agencies may wish to specify that eligible PMI/ LMI providers must be subject to prudential regulation, either on a solo or consolidated basis.

Beyond the issue of PMI/ LMI in the context of LTV, we also urge the federal banking agencies to consider the extent to which a PMI/ LMI guarantee might appropriately serve to adjust a residential mortgage exposure's overall risk profile. This may include, for instance, an adjustment to Kg or the introduction of a PMI/ LMI guarantor specific risk-weight. Assuming that a PMI/ LMI provider meets the 'investment grade' standard described above, there is in our view, no clear reason why it should not be viewed as an 'eligible guarantor'. In the context of a market such as Australia, this would enable prudently underwritten LMI-supported residential mortgage exposures to benefit from the lowest possible risk-weight on the basis of the presence of both strong collateral and a full guarantee on the loan balance due. In our view, any residual concerns regarding the strength or correlation of a PMI/ LMI guarantee, including during periods of idiosyncratic or significant financial market stress, could be addressed via the introduction of an appropriately calibrated supervisory factor.

Simplified Supervisory Formula Approach – Definition of a Re-Securitization

Under the proposed Basel NPRs, a re-securitization is defined as any 'securitization in which one or more of the underlying exposures is a securitization exposure'. For instruments that are classified as re-securitizations, Kg must be determined on the basis of the capital charge that applies to the underlying securitizations as opposed to the underlying loans. In addition, the SSFA incorporates a supervisory factor for re-securitizations of 1.5, or three times the standard factor of 0.5. While we acknowledge the concerns of the federal banking agencies relative to collateralized debt obligations and other similar structures that packaged exposures in highly correlated asset classes and junior positions and experienced significant problems during the financial crisis, we believe that the intended definition of a re-securitization is too broad and will unnecessarily restrict access to high-quality investment assets.

As an initial matter, we believe that it is appropriate for the federal banking agencies to introduce a *de minimus* exemption for securitization structures that may include very limited amounts of exposure to other securitized assets. As an example, it is commercial practice for corporate loan securitizations, or collateralized loan obligations ("CLOs"), to include a small amount of exposure to other corporate-loan backed securitizations, typically less than 5% of the overall value of the portfolio. This is designed for risk diversification purposes and to facilitate the investment of limited amounts of short-term cash.

In our view, the capital implications of defining CLOs and other similar instruments as re-securitizations would be excessive and broadly disproportionate to any potential balance sheet risk. We therefore recommend that the federal banking agencies modify the intended definition of a re-securitization to exclude any securitization structure in which 5% or less of the underlying exposures are securitization exposures. Alternatively, the federal banking agencies may wish to introduce a methodology wherein Kg and the SSFA supervisory factor p (*i.e.* 1.5), are adjusted based on the percentage of securitizations held in the re-securitization structure, up to a maximum of 5%.

Furthermore, State Street is concerned that the intended definition of a re-securitization would capture securitization structures, such as re-REMICs, involving only one underlying reference securitization. In our view, these securitization structures represent a recapitalization of the original underlying instrument rather than a re-securitization, and are analogous to owning a super-senior or senior mezzanine position in the underlying reference securitization.

The capital implications of treating re-REMICs and other similar structures as re-securitizations are extreme and clearly disproportionate to the underlying risk. By way of example, we have analyzed the impact of the intended framework on Citigroup Mortgage Loan Trust 2012-5 2A1, a re-REMIC with one underlying bond (CHL Pass-Through Trust 2005-HYB4 2A1) comprised of 683 individual residential mortgage loans. Notwithstanding the presence of broad credit enhancements that materially reduce the potential for further losses, this security generates an SSFA risk-weight charge of 473.8%. This contrasts with the 20% SSFA risk-weight charge that would apply if the structure were deemed a traditional securitization and the 363.8% SSFA risk-weight charge that applies to the underlying bond exposure.

In effect then, the intended approach results in a significantly elevated risk-based capital charge, including a greater charge for the restructured senior portion of the underlying reference securitization than for the reference securitization itself. In our view, this anomalous outcome can be addressed by revising the definition of a re-securitization to require the presence of more than one underlying securitization. Alternatively the federal banking agencies may wish to exclude from the definition of a re-securitization any securitization structure involving a senior position in one underlying reference securitization.

CONCLUSION

Thank you once again for the opportunity to comment on the important matters raised within the Basel NPRs. To summarize, State Street supports the introduction of an enhanced regulatory capital framework for US banks, but recommends certain modifications to the intended framework, designed to ensure proper alignment and also recognition of the considerable progress made by banks in the measurement and management of their risk. Our recommendations are grouped into three broad categories: the definition of regulatory capital, the treatment of securities lending and the treatment of securitized assets.

More generally, in order to provide sufficient lead time and address likely market confusion, we recommend that the federal banking agencies introduce the Advanced Approach and Standardized Approach frameworks on a uniform basis beginning January 1, 2015. We strongly support the proposed use of the Advanced Approach framework for the calculation of capital buffers by Advanced Approach banks, and request confirmation that the Standardized Approach calculation for such banks is meant to apply at the level of the consolidated entity. We support, in turn, the introduction of an institution specific methodology for the calculation of a dollar-for-dollar risk-weight equivalent regulatory capital charge.

In terms of the definition of regulatory capital, we recommend that the existing treatment of unrealized gains and losses of AFS securities in regulatory capital be maintained, or alternatively the introduction of a replacement filter designed to address interest rate-related fluctuations. We also recommend the exclusion of investments in 40 Act funds and their foreign equivalents from the required deduction from regulatory capital of exposures to unconsolidated financial institutions.

In terms of the treatment of securities lending, we strongly urge the continued permissibility of Simple VaR methodologies in the calculation of exposures to securities lending transactions under the Standardized Approach. We also recommend the removal of the 5,000 transaction threshold from the definition of a higher risk netting set. Alternatively, we recommend its calculation on a quarterly average basis, clarification regarding the definition of a transaction and the introduction of a materiality threshold for margin disputes. Furthermore, we recommend the more granular treatment of exposures to bank-affiliated securities firms under the Standardized Approach. Finally, we emphasize our strong support for the current on-balance sheet measurement of securities lending transactions for purposes of the supplementary leverage ratio.

In terms of the treatment of securitized assets, we request the exclusion of exposure to state and other US public pension fund and benefit plans, as well as traditional custody bank activities from the definition of a securitization. Furthermore, we recommend the grand-fathering of SSFA requirements for RMBS originated prior to the issuance of a final rule, and also the use of a 'prudently underwritten' standard in the case of foreign RMBS. In addition, we recommend recognition of PMI/ LMI in the calculation of LTV, the possible broader recognition of PMI/ LMI in the context of the SSFA and modifications to the intended definition of a re-securitization.

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

Sincerely,

Stefan M. Gavell