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Robert de V. Frierson, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

RE: Docket Number R-1534 and RIN Number 7100-AE48

Via e-mail: regs.comments@federalreserve.gov

<u>Notice of Proposed Rulemaking – Single-Counterparty Credit Limits for Large Banking Organizations</u>

Dear Sir/ Madam:

State Street Corporation ("State Street") welcomes the opportunity to comment on the Notice of Proposed Rulemaking ("proposed rule") issued by the Board of Governors of the Federal Reserve System ("FRB") regarding the implementation of Section 165(e) of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") which mandates the establishment of single counterparty credit limits ("SCCL") for certain domestic and foreign bank holding companies ("BHC") operating in the United States ("US"). The proposed rule follows two initial rounds of rulemaking by the FRB in December 2011 and December 2012, as well as publication of the Basel Committee on Banking Supervision's ("Basel Committee") final framework for measuring and controlling large exposures in April 2014.[1] State Street has been an active participant in the policy debate regarding the appropriate design of the SCCL and the large exposure frameworks, providing comments in April 2012 on the FRB's proposed rule and comments in June 2013 on the Basel Committee's proposed approach, emphasizing the potential unintended impact of these measures on the custody bank business model.

[1] 'Supervisory Framework for Measuring and Controlling Large Exposures', Basel Committee on Banking Supervision (April 2014).

Headquartered in Boston, Massachusetts, State Street is a stand-alone custody bank that specializes in the provision of financial services to institutional investor clients. This includes investment servicing, investment management, data and analytics, and investment research and trading. With $26.8 trillion in assets under custody and administration and $2.3 trillion in assets under management as of March 31, 2016, State Street operates in 30 countries and in more than 100 geographic markets. State Street is organized as a US BHC, with operations conducted through several entities, primarily its wholly-owned insured depositary institution ("IDI") subsidiary, State Street Bank and Trust Company. We offer investment management services through State Street Global Advisors ("SSGA"), which is one of the world's largest bank-owned asset managers. Our comments in this letter focus on the application of the proposed rule to 'major covered companies', which is defined by the FRB as any banking organization which has been designated as a global systemically important bank ("G-SIB") or non-bank financial company subject to supervision by the FRB.

We strongly support the risk-mitigation benefits of Section 165(e) of the Dodd-Frank Act and believe that an appropriately structured SCCL framework has the potential to greatly reduce systemic risk within the US financial system. Furthermore, we appreciate the iterative manner in which the FRB has undertaken its policy mandate, including its openness to industry feedback that is consistent with its statutory goals and its decision to await the outcome of the Basel Committee's large exposure regime prior to finalization of its own rule. We welcome many of the adjustments which the FRB has made to the SCCL framework since its initial rounds of consultation. This includes the decision to exclude all zero-risk weighted sovereigns from the definition of a 'counterparty', the decision to exempt exposures to qualifying central counterparties ("QCCP") and the decision to exempt intra-day exposures in order to 'help minimize the impact of the proposed rule on the payment and settlement of securities transactions'.[2]

Nevertheless, we continue to have serious concerns with the methodology proposed by the FRB for the measurement of exposures to agency-indemnified securities lending transactions ("agency-indemnified SFTs") since that methodology greatly overstates underlying credit risk and therefore has the potential to severely disrupt the ability of custody banks, such as State Street, to support access to pools of investment assets held by their institutional investor clients, used among other, to facilitate market liquidity and efficiency, meet growing demand for high-quality collateral in support of the centralized clearing of over-the-counter ("OTC") derivatives transactions, and provide long-term investors' with access to low-risk, incremental returns. Furthermore, we also have more targeted concerns related to: the proposed definition of a 'subsidiary' for purposes of determining entities which fall within the scope of a 'covered company' and questions posed by the FRB regarding the proper treatment of sponsored or advised funds; the applicability of the proposed 'look-through' requirement for exposures resulting from the provision of traditional custody services to investment funds; and the lack of

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[2] FRB Notice of Proposed Rulemaking, page 62.

an exemption for short-dated exposures resulting from the provision of payment, settlement and asset administration services.

Our perspective in respect of the proposed rule is broadly informed by our status as one of the world's largest providers of custody services to institutional investor clients. Global custody banks, such as State Street, employ a highly specialized business model focused on the provision of fee-based services to institutional investor clients, rather than the generation of yield from credit risk assets. These clients, which include asset owners, asset managers, official institutions and insurance companies, contract with custody banks to ensure the proper safekeeping of their investment assets, as well as the provision of a broad range of related financial services. These services include access to the global settlement infrastructure in order to complete the purchase or sale of investment securities; various asset administration functions, such as the processing of income and other interest payments, corporate action events, tax reclamations and client subscriptions and redemptions; and the provision of banking services, notably access to deposit accounts in order to facilitate day-to-day transactional activities. In addition, custody banks provide a series of value-added services that result from client assets held in custody, including agency-indemnified SFTs. The importance of these services to the custody bank business model can be seen in the large amount of revenue derived from fee-related activities. As an example, in Q1 2016 fee revenue comprised 79.3% of our total revenue.

Furthermore, the stand-alone custody banks have balance sheets which are constructed differently than other more traditional banks with extensive retail, commercial and investment banking operations. Indeed, the custody bank balance sheet is liability driven and expands not through asset growth, but through the organic development of client servicing relationships that, over time, translate into increased volumes of highly stable deposits. These deposits, rather than various sources of wholesale funding, provide the largest part of the custody banks' liabilities. For instance, as of Q1 2016, client deposits made up more than 76% of State Street's total balance sheet. In turn, these highly stable deposits are used to fund the purchase of large and well-diversified portfolios of investment assets which generate conservative amounts of net interest revenue. Importantly, custody banks acquire deposit liabilities as a direct result of the financial services they provide. In other words, the cash deposits that come on to the custody bank balance sheet, and which are monetized through the purchase of high-quality investment assets, are driven by customer-related needs and not by the custody banks' financing decisions.

We appreciate the opportunity to offer insight relative to the implications of the proposed rule on our role as a custodial entity, a role that is widely understood by the market and by the supervisory community as providing important benefits for the safety of client assets and the stability of the financial system. Our policy recommendations, which are discussed in greater detail below, can be summarized as follows:

- Implementation of an approach for the measurement of exposures to agency-indemnified SFTs which is consistent with the intended approach for the measurement of exposures to OTC derivatives transactions; specifically, permission for 'covered companies' to make use of their supervisory approved value-at-risk ("VaR") methodologies pending finalization of the Basel Committee's revised 'comprehensive approach' for SFTs and its implementation in the US regulatory capital framework

- Adjustment to the proposed definition of a 'subsidiary' for purposes of determining the scope of a 'covered company' subject to the SCCL framework, so that it is based on the proposed definition of a 'counterparty' rather than Section 2(a) of the Bank Holding Company Act, along with confirmation that the definition of a 'subsidiary' does not extend to investment funds which are either sponsored or advised by a 'covered company';
- Clarification that the 'look-through' requirement for exposures to a 'securitization fund, investment fund or other special purpose vehicle' (collectively "investment fund structures") only applies to exposures that result from investments made by a 'covered company' in such funds, and that in any event the 'look-through' requirement does not extend to exposures that result from the provision of traditional custody services to an investment fund client, including payment, settlement and asset administration services; and
- Introduction of an exemption for short-dated exposures arising from the provision of traditional custody services which is consistent with the exemption contained in the EU large exposure regime, or alternatively, the implementation of a 'cure period' for such exposures based on the longest timeframe specified in the EU large exposure regime, or five business days.[3]

We have participated in the development of the responses prepared by various financial services trade groups, notably the joint submission from The Clearing House Association, the American Bankers Association, The Financial Services Roundtable, and the Securities Industry and Financial Markets Association, and the submission from The Risk Management Association, and we broadly support the observations and recommendations made therein. Our intention with this letter is to highlight issues of particular concern to State Street that result from our custody bank business model.

TREATMENT OF SECURITIES FINANCING TRANSACTIONS

The FRB proposes to require covered companies to measure their SFT exposures, including exposures to agency-indemnified SFTs, using the highly risk insensitive haircut-based 'comprehensive approach' as prescribed in the US implementation of the Basel III accord.[4]

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[3] 'EU Regulation No. 575/2013 of the European Parliament and of the Council of 26 June 2013 on Prudential Requirements for Credit Institutions and Investment Firms and Amending Regulation EU No. 648/2012', CRR Article 390(6).

[4] 'Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Capital Adequacy, Transition Provisions, Prompt Corrective Action, Standardized Approach for Risk-weighted Assets, Market Discipline and Disclosure Requirements, Advanced Approaches Risk-Based Capital Rule, and Market Risk Capital Rule', Office of

When explaining its decision to rely on this approach, the FRB acknowledges the concerns raised by respondents during the initial round of consultation on the SCCL framework that the 'comprehensive approach' fails to account for certain economic variables in SFTs, including the impact of the correlation between securities placed on loan and the collateral received. Furthermore, it notes efforts by the Basel Committee to develop a revised version of the 'comprehensive approach' which permits the netting of long and short transactions, and which makes use of two factors; one to account for the impact of correlation on a market-wide basis and one to account for portfolio diversification. This revised approach has been well-received by the industry and the supervisory community given its effectiveness in addressing material flaws in the existing standardized approach for SFTs, and it is the Basel Committee's intention to finalize its work on the revised methodology by year-end 2016. Nevertheless, the FRB has rather surprisingly chosen to discount the Basel Committee's work based on the view that the revised 'comprehensive approach' would 'increase the complexity of the (SFT) framework and potentially make the (SFT) framework susceptible to arbitrage.'[5]

In contrast, the FRB takes a decidedly more risk-sensitive view of OTC derivatives transactions, where it expresses concern that the Basel III current exposure measure ("CEM"), 'may not take fully into account correlations and netting relationships, and therefore.....may overstate counterparty credit risk."[6] Moreover, it notes the Basel Committee's efforts to develop an alternative methodology that more accurately reflects the credit risk of OTC derivatives transactions, or the 'standardized approach for counterparty credit risk' ("SA-CCR"), and affirms its intention to consider 'the benefits of incorporating (the) SA-CCR in the SCCL rule at such time as the (FRB) considers the benefits of SA-CCR for risk-based capital purposes.'[7] In the interim, it proposes to permit 'covered companies' to calculate their derivatives exposures 'using any methodologies that the covered company is permitted to use under the (FRB's) risk-based capital rules', including approved internal models.[8]

We strongly oppose the use of the haircut-based 'comprehensive approach' for the measurement of SFT exposures in the SCCL framework, and instead urge the FRB to implement an alternative approach that is broadly consistent with the proposed treatment of OTC derivatives transactions. This reflects the substantial methodological flaws of the 'comprehensive approach' in its current form, which vastly overstate credit risk in SFTs and therefore the 'maximum possible loss' that a 'covered company' may incur. Furthermore, by implementing an SCCL framework that incorporates broadly divergent methodologies for the measurement of exposures to SFTs and the measurement of exposures to OTC derivatives transactions, the FRB will encourage the migration of financial activity away from the physical

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the Comptroller of the Currency and Board of Governors of the Federal Reserve System, Federal Register, Volume 78, No. 198 (October 11, 2013).

[5] FRB Notice of Proposed Rulemaking, page 40.

[6] FRB Notice of Proposed Rulemaking, pages 34-35.

[7] FRB Notice of Proposed Rulemaking, page 35.

[8] FRB Notice of Proposed Rulemaking, page 34.

SFT market in favor of derivatives-based alternatives, due to the far more favorable regulatory treatment of the underlying credit risk.

This has substantial implications for the ability of custody banks to continue to support access to pools of investment assets held by their institutional investor clients, used to enhance market liquidity, reduce volatility, improve price discovery and facilitate the exchange of collateral, and therefore the long-term health of the financial markets. The resulting inevitable contraction of the SFT market is unnecessary to meet the FRB's policy objectives and can readily be addressed with modest adjustments to the SCCL framework that avoid regulatory arbitrage, promote consistency with the evolving credit risk framework, improve the risk-sensitivity of standardized methodologies, and reduce unnecessary operational complexity.

Measurement of Credit Exposure for Agency-Indemnified SFTs

Custody banks have long provided agency-indemnified SFTs to their institutional investor clients under the active supervision of prudential regulators. The SFT market is characterized by and is subject to well-developed risk controls. This includes the use of Master Securities Lending Agreements to specify each party's legal rights and obligations, 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 appropriate to ensure ongoing over-collateralization. Custody banks 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. 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.

'Covered companies' that are active in the SFT market, including custody banks with large agency lending programs, generally use simple VaR methodologies when calculating their counterparty credit exposures. These models were initially approved for use by the FRB under Basel I. Similar methodologies have since been adopted by the Basel Committee and incorporated into various national prudential frameworks as part of both Basel II and Basel III. These models, which State Street has used in various capacities since the mid-1990s, have evolved as banks and supervisors have developed additional expertise, including on the basis of ongoing, detailed regulatory scrutiny. They have also benefitted from significant multi-million dollar investments and extensive systems upgrades. As such, while we acknowledge the FRB's decision to rely on standardized measures of credit risk as the basis for calibration of the SCCL framework, we believe that simple VaR and other model-based methodologies most accurately reflect the economic risk of SFTs.

Limitations of the Comprehensive Approach

Under the proposed rule, 'covered companies' would be required to measure their SFT exposures using the haircut-based 'comprehensive approach' prescribed in the existing US implementation of the Basel III accord. This results in a dramatic overstatement of credit risk that bears no resemblance to the underlying structure of an SFT. Indeed, as proposed, exposures to SFTs would equal the difference between (i) the value of the securities lent, plus a risk-insensitive volatility factor, and (ii) the value of the collateral accepted, less a risk-insensitive volatility factor. In addition, a further adjustment is required in cases where the currency of the securities placed on loan differs from the currency of the collateral received.

This proposed methodology suffers from several significant limitations. First, the intended volatility factors are arbitrary and do not appear to reflect empirical considerations, such as industry experience during times of financial market stress. This includes the lack of recognition for 'flight to quality', where certain types of securities, such as equities and corporate bonds, would be expected to decline in value, whereas other 'safe' assets, such as US Treasuries and other similar sovereign obligations would be expected to rise. Second, the proposed methodology provides no recognition for diversification within the lending or collateral portfolios, assuming at all times a positive and highly implausible correlation of 1.00. Similarly, the 'comprehensive approach' does not recognize the correlation that exists between securities lent and collateral received, with market values assumed to move in opposite directions. This is based on the flawed assumption that all securities lent and all collateral received have a constant correlation of -1.00. Third, the intended methodology provides very limited opportunities to net transactions, which is only allowed at the level of the individual security. Finally, the adjustment proposed for cross-currency transactions (5.7%) overstates volatility for most currency pairs by a factor of almost two.

The result is a standardized measure of exposure for agency-indemnified SFTs that is multiples higher than the 'maximum possible loss' that a 'covered company' could sustain to a single counterparty. The impact of the 'comprehensive approach' is particularly pressing in non-US markets, where the use of equities and other non-cash collateral in agency-indemnified SFTs is common. A specific example of the outsized impact of the 'comprehensive approach' on the measurement of SFT exposures can be found in the enclosed Annex 1 of our comment letter.

Benefits of Securities Lending to the Financial Markets and Long-term Investors

Securities lending plays a relatively unknown but critical role in the day-to-day operation of the financial markets. It helps facilitate the timely settlement of securities transactions, the efficient exchange of collateral, and the conduct of both market making and hedging activities. Securities lending helps to increase market liquidity and enhances the overall price-discovery process by supporting various asset allocation strategies. This includes the ability to enter into short-selling transactions which in the vast majority of national jurisdictions must legally be supported by the borrowing of shares through the securities lending market.

The benefits of securities lending to the financial markets are well-understood by the supervisory community. As an example, in a bulletin entitled 'Developments in the Global Securities Lending Market', the Bank of England states: 'Securities lending plays an important role in supporting financial markets and brings positive benefits to the financial system….Securities lending can improve market liquidity, potentially reducing the cost of trading and increasing market efficiency. This enables better price discovery and can reduce price volatility, which can facilitate financial and non-financial companies in raising funding and capital and also helps investors buy and sell securities. By creating access to securities already outstanding in the market, securities lending....(helps increase) the total supply of securities available to support...market making and trade settlement.'[9] Similarly, in a February 2013 Staff Report, the Federal Reserve Bank of New York emphasizes that 'the markets for repos and securities lending are crucial for the trading of fixed-income securities and equities. Repos are especially important for allowing arbitrage in the Treasury, agency, and agency mortgage-backed securities markets, thus enhancing price discovery and market liquidity. Securities lending markets play key roles in allowing shorting, both in fixed-income and equity markets.' [10]

Furthermore, securities lending provides important benefits for institutional investors, such as pension plans and mutual funds, by enabling the generation of low-risk, incremental returns on portfolios of investment assets. These returns are used to enhance performance and offset administrative and other portfolio costs. This can be particularly beneficial for public funds which often have limited administration budgets and which face substantial pressure to address structural underfunding. As an example, based on a sample of 90 US public pension funds, the research and consulting firm Finadium determined that for those funds actively participating in the securities lending market, average cumulative returns from securities lending activities over an eight year-period from 2006 to 2013 totaled 34 bps. [11] Similarly, a sample of 357 investment funds run by ten leading asset management firms produced cumulative returns on securities lending activities in the period from 2011 to 2015 of 19 bps.[12] Although returns on securities lending portfolios are subject to variability based upon a number of factors, such as the size of the portfolio and the type of assets placed on loan, these results emphasize the critical point that the benefits of securities lending are substantial and extend well-beyond the narrow confines of the financial industry.

Indeed, by dramatically overstating the credit risk in agency-indemnified SFTs, the FRB's intended approach will inevitably trigger a further contraction of the already greatly diminished SFT market, with important negative implications for both the financial system and the investor community. Estimates from industry sources developed in response to the FRB's initial SCCL proposal in December 2012 highlighted a likely decline in agency-indemnified SFTs of 30% to 50% from already significantly reduced post-financial crisis levels.[13] While the intensity of this

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[9] 'Developments in the Global Securities Lending Market', Matthew Dive, Ronan Hodge, Catrin Jones and James Purchase, Bank of England Bulletin, (Q3 2011).
[10] 'Repo and Securities Lending', Tobias Adrian, Brian Begalle, Adam Copeland and Antoine Martin, Federal Reserve Bank of New York Staff Report Number 529 (December 2011 – Revised February 2013), page 1.
[11] 'Securities Lending, Market Liquidity and Retirement Savings: the Real World Impact', Finadium, November 2015, page 12.
[12] 'Securities Lending, Market Liquidity and Retirement Savings: the Real World Impact', Finadium, November 2015, page 12.
[13] Committee on Securities Lending of the Risk Management Association 'Comment Letter on Issues Concerning Application of Proposed Single Counterparty Credit Limits to Agency Securities Lending and Related Transactions'

decline will be mitigated by several of the adjustments made to the SCCL framework in the FRB's current proposal, including clarification of the five-day liquidation period for 'repo-style' transactions, the industry still anticipates a substantial and unwarranted reduction in the size of the SFT market, which compels consideration of alternative approach which better balances the desire for a simple, comparable and conservative measure of risk exposure, with appropriate risk-sensitivity.

The Revised Comprehensive Approach

Following upon its first consultation in December 2014, the Basel Committee published in late-2015 a second consultation on revisions to the standardized approach for credit risk.[14] The aim of this second consultation was to address limitations in the existing standardized framework, notably the excessive variability of risk-weighted assets among banks and national jurisdictions, while improving the risk-sensitivity of standardized measures of risk. In the case of SFTs, this centered on the introduction of an amended version of the 'comprehensive approach' designed to address three major structural flaws: (i) the lack of recognition for the correlation that exists between securities placed on loan and the collateral received, (ii) the lack of recognition for the diversification of assets within both lending and collateral pools, and (iii) the inability to net transactions subject to a qualifying master netting agreement at the counterparty level.

More specifically, the Basel Committee proposes three adjustments to the formula used to calculate potential price changes in the market value of SFTs within a netting set. First, the formula has been revised to permit the offsetting of market risk from long and short transactions, with long transactions reflected as a positive exposure amount and short transactions as a negative exposure amount. Second, the resulting net exposure amount is multiplied by a factor of .4 to reflect the correlation that exists between securities placed on loan and the collateral received without the need for a banking entity to consider individual trading pairs. Third, the formula incorporates an additional factor of .6 applied to the gross SFT exposure amount. This gross amount is then divided by the square root of the number of securities within the netting set in order to approximate the impact of portfolio diversification. The number of securities in the netting set for which the square root is applied is subject to an adjustment for smaller securities with a market value representing less than one-tenth, or 10% of the value of the largest position within the netting set. This last adjustment is intended to address the potentially outsized impact of exposures to securities with a market value that may not reflect the presence of 'true' diversification.

The result of these changes is a standardized methodology for the measurement of SFT exposures which provides for a far more granular and appropriate assessment of credit risk. Indeed, we estimate exposure amounts using the revised 'comprehensive approach' which are

(April 30, 2012); page 7. We estimate a 50% reduction in size of the securities lending market since its peak in 2007.

[14] 'Second Consultative Document: Revisions to the Standardized Approach for Credit Risk', Basel Committee on Banking Supervision (December 2015).

2.5x to 3x greater than simple VaR methodologies. This compares with exposure amounts using the existing haircut-based 'comprehensive approach' which are 8x to 10x greater than simple VaR methodologies. Although fairly conservative, we view these outcomes as reasonable in a standardized measure of credit risk and note that they are generally consistent with the exposure amounts observed by the US custody banks in the context of the annual FRB stress test of banks.[15]

Notwithstanding the FRB's concern regarding undue complexity, the Basel Committee's revised 'comprehensive approach' is simple to use, certainly when compared to both CEM and the SA-CCR for OTC derivatives transactions. As such, it is readily adoptable by the range of BHCs subject to the proposed SSCL framework. Furthermore, we do not understand the reference which the FRB makes to the potential susceptibility of the revised 'comprehensive approach' to arbitrage, which we view as remote. Indeed, if the FRB is concerned about the prospect of arbitrage within the SCCL Framework, it should focus on the implications of an approach which relies on two vastly different methodologies for the measurement of exposures to SFTs and OTC derivatives transactions. This reflects the ease with which OTC derivatives transactions can be used to mimic the economic exposure of an SFT.

There are already signs that the market is shifting towards the broader use of derivatives-based synthetics. According to Finadium, this includes efforts by prime brokers to encourage their clients to engage in swap transactions over physical loans, where possible, 'due to the highly attractive capital benefit'.[16] In our view, this trend is bound to accelerate if 'covered companies' are incentivized by the SCCL framework to favor OTC derivatives transactions over economically equivalent SFTs, thereby leading to the further concentration of credit risk in an already substantially over-sized market. Furthermore, a shift in the market from physically settled SFTs to OTC derivatives transactions will cause lasting damage to market liquidity. This is because 'every trade conducted as a swap over the physical (equivalent) removes liquidity from buyers and sellers of securities, leaving wider spreads and fewer opportunities for price discovery….as more trades move away from the primary market to secondary trading venues, in this case OTC derivatives, the impact is magnified across both the underlying and swaps market'.[17]

We therefore strongly recommend that the FRB implement an approach for the measurement of SFT exposures in the SCCL Framework which mirrors the intended approach for the measurement of exposures to OTC derivatives transactions. More specifically, we urge the FRB not to implement the highly risk-insensitive haircut-based 'comprehensive approach', instead permitting covered companies to continue to make use of supervisory approved VaR methodologies for the measurement of their SFT exposures, until such time as the FRB

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[15] The Board of Governors of the Federal Reserve System Comprehensive Capital Analysis and Review (CCAR) program.
[16] 'Securities Lending, Market Liquidity and Retirement Savings: the Real World Impact', Finadium, November 2015, page 21.
[17] 'Securities Lending, Market Liquidity and Retirement Savings: the Real World Impact', Finadium, November 2015, pages 21-22.

considers the benefits of incorporating the revised 'comprehensive approach' proposed by the Basel Committee within the US risk-based capital framework.

This is consistent with the position taken by the Basel Committee in its own large exposure framework, where it notes: 'The Committee is undertaking a review of the standardized approach for credit risk, which includes a review of the comprehensive approach used for the measurement of SFT exposures. The Committee expects that the forthcoming revised comprehensive approach.....will be appropriate for large exposure purposes. In this case, all banks must use the (revised) comprehensive approach.....The Committee's expectation is that the review of the standardized approach will have been completed in advance of the implementation deadline for the large exposure framework, but in the event of a delay, banks would be allowed to use the method they currently use for calculating their risk-based capital requirements against SFTs.[18]

DEFINITION OF A CONTROLLED SUBSIDIARY AND THE TREATMENT OF SPONSORED FUNDS

Under the proposed rule, the credit exposure limits foreseen in the SCCL framework apply to a 'covered company' on a consolidated basis. This is defined by the FRB to extend beyond financial consolidation to also include subsidiaries which are directly or indirectly controlled by the 'covered company', using the control standard found in Section 2(a) of the Bank Holding Company Act. Nevertheless, the FRB requests the industry's views on whether the definition of a 'subsidiary' should instead be based on the control test specified in the proposed rule for the aggregation of financial entities to a 'counterparty'. Under this alternative, a subsidiary would be defined as 'any entity that a covered company (1) owns, controls, or holds the power to vote 25% or more of a class of voting securities, (2) owns or controls 25% or more of the total equity, or (3) consolidates for financial reporting purposes'.[19]

We strongly support this alternative approach. This reflects our concern that the proposed SCCL framework is unduly complex and that its multiple and overlapping requirements related to the aggregation of exposures may unwittingly capture financial entities which are legally distinct from the 'covered company' and where there is no evidence of any material control or economic interdependence. As an example, while the reference in Section 2(a)(b) of the Bank Holding Company Act relative to the ability of a 'covered company' to 'control in any manner the election of a majority of directors or trustees of the (entity)' is generally understood not to encompass '40 Act funds which are required by law to have an independent board of directors, this is not the case for EU Undertakings for Collective Investments in Transferable Securities ("UCITS") which although organized as distinct legal entities and subject to stringent regulation, are not subject to the same independence standard. Similarly, we are concerned that the

[18] 'Supervisory Framework for Measuring and Controlling Large Exposures', Basel Committee on Banking Supervision (April 2014), paragraph 34, page 7.
[19] FRB Notice of Proposed Rulemaking, page 14.

'controlling influence' test in Section 2(a)(c) does not account for the legal structure of common and collective investment funds, which are bank administered trusts that manage commingled assets on behalf of institutional investor clients, with the bank acting as a fiduciary and holding legal title to the funds' assets.

Although not without its limitations, notably its implications for joint ventures where a 'covered company' may only have a minority interest, the proposed standard for the aggregation of exposures to a 'counterparty' offers a less subjective and therefore clearer test of 'control', better suited to the range of financial entities and legal structures which exist in today's financial system. From our perspective as one of the world's largest bank-owned asset managers, this includes various types of investment funds with a distinct legal existence, where the 'covered company' takes no credit risk and where there is no market or investor expectation of support, but which might otherwise not meet the requirements specified in Section 2(a) of the Bank Holding Company Act. Furthermore, by relying on one standard for the identification of a control relationship applicable to both 'covered companies' and 'counterparties', the FRB would help to mitigate some of the substantial compliance challenges that the industry will face when implementing the SCCL final rule.

In the preamble to the proposed rule, the FRB specifies that 'if an investment fund or vehicle is not controlled by a covered company, the exposures of such a fund or vehicle to its counterparties would not be aggregated with those of the covered company for purposes of the proposed SCCL (framework).'[20] This would include investment funds that the 'covered company' either sponsors or advises. We strongly support this approach which properly reflects not only the legal nature of the relationship that exists between a 'covered company' and its sponsored or advised funds, but also the specific obligation of the asset manager to its clients, including the obligation to meet the investment objectives of the fund. This requires the asset manager to transact with a full range of counterparties in the financial markets, unconstrained by factors which fall outside of its investment mandate, such as the credit exposure limits that may apply to the parent entity. Indeed, any bank-owned asset manager that could not enter into a transaction on behalf of a sponsored or advised fund with a given counterparty due to an actual or potential breach of the SCCL framework at the parent entity, would face the almost certain loss of the underlying business mandate and expose itself to potential legal action by the client. In effect then, there is an inherent tension between the role of an asset manager as a directed agent and the requirements of the proposed SCCL framework for bank-owned asset managers which make it unreasonable to require the aggregation of sponsored or advised funds, barring the presence of a material risk exposure.

As such, we do not support the suggestion made in Question 3 of the proposed rule that the definition of a 'subsidiary' should be expanded to include sponsored or advised funds, which would thereby fall within the definition of a 'covered company' for purposes of the SCCL framework. While the proposed rule offers no rationale for this suggested alternative approach,

[20] FRB Notice of Proposed Rulemaking, page 13.

we assume that it reflects some level of concern that a 'covered company' could feel compelled to provide financial support to such funds, in the absence of any contractual obligation, should such funds experience financial stress in order to protect the 'covered company' from potentially adverse reputational risk, or what the Basel Committee refers to as 'step-in' risk.

As we emphasized in our recent comment letter to the Basel Committee on the 'Identification and Measurement of Step-in Risk', we do not believe that the supervisory community has demonstrated the existence of a concern regarding sponsored or advised funds that would warrant a radical change in their prudential treatment.[21] Furthermore, supervisory assumptions relative to the presence of 'step-in' risk in asset management activities generally fail to consider the broad range of legal and regulatory mandates which substantially limit the ability of a bank, in this case a 'covered company', from providing financial support to a sponsored or advised fund. In the case of the US, this includes:

- Section 23A of the Federal Reserve Act which limits a bank's 'covered transactions' with any single affiliate, including a sponsored fund, to no more than 10% of the bank's capital stock and surplus, and further limits 'covered transactions' with all affiliates combined, including sponsored funds, to no more than 20% of the bank's capital stock and surplus;
- Section 23B of the Federal Reserve Act which requires that 'covered transactions' between a bank and its affiliates be executed at 'arm's length, on market terms', while also expanding the definition of 'covered transactions' to include any payment of funds to an affiliate;
- Interagency guidance issued in 2004 which alerts banks to the safety-and-soundness implications of potential financial support to sponsored funds, a description of the legal impediments to such support and three core principles that banks must follow in respect of such support, namely that a bank (i) should not inappropriately place its resources and reputation at risk for the benefit of a fund's investors and creditors, (ii) should not violate the limits and requirements of Section 23A and Section 23B of the Federal Reserve Act, or other legal mandates and supervisory conditions which may be imposed by the US prudential regulators, and (iii) should not create any expectation that a bank will support its advised or sponsored funds;[22] and
- Commitments made by banks in the context of their recovery and resolution planning efforts and annual stress testing requirements, not to provide financial support to a sponsored fund or other unconsolidated entity, commitments which are driven by specific regulatory mandates emanating from the Dodd-Frank Act and other aspects of the post-financial crisis regulatory framework.

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[21] 'Consultative Document – Identification and Measurement of Step-in Risk', State Street Comment Letter in Response to the Basel Committee on Banking Supervision Consultation (December 2015).

[22] 'Interagency Policy on Banks and Thrifts Providing Financial Support to Funds Advised by the Banking Organization or its Affiliates', Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Office of Thrift Supervision and the Federal Deposit Insurance Corporation (January 5, 2004).

Similarly, also generally overlooked by the supervisory community are restrictions on the provision of financial support to a sponsored fund or other unconsolidated entity, which have been agreed to by a bank as a matter of contract law and which define the relationship between a bank and its asset management activities, and therefore the scope of potential unresolved 'step-in risk'.

Moreover, concerns regarding potential 'step-in risk' overlook the reality that the vast majority of sponsored or advised funds have never received financial support from a regulated banking entity and that there is no market or investor expectation of such support. While we concede that certain money market funds ("MMFs") did receive support during the financial crisis, existing and pending regulations substantially mitigate the potential for future instances of such support. In the case of the US, this centers on the adoption of new MMF rules by the Securities and Exchange Commission ("SEC") which eliminate the assumption of an implicit price floor by requiring, as of October 2016, the introduction of a floating net-asset value for all institutional prime and municipal MMFs. Furthermore, these rules permit the imposition of liquidity fees and redemption gates in the event of a decline in amounts of available liquid assets, along with enhanced portfolio diversification, reporting and disclosure mandates. In the case of the EU, proposed legislation for MMFs would require the substantial strengthening of liquidity risk management practices and would bar the provision of sponsor support.[23]

More broadly, there are numerous policy initiatives which are being pursued to further strengthen the regulatory framework for investment funds. This includes new liquidity risk management requirements, restrictions on the use and reporting of derivatives transactions, and potential regulatory action to implement stress-testing and resolution protocols. Consistent with the division of regulatory responsibilities in the US, these efforts are being driven by financial market regulators, and we do not believe that Section 165(e) was intended by Congress as a substitute for SEC regulation of investment funds. We therefore believe that the FRB should not seek to expand the SCCL framework beyond its core statutory foundation, as suggested in Question 3 of the proposed rule, to include either sponsored or advised funds.

LOOK-THROUGH REQUIREMENT FOR EXPOSURES TO INVESTMENT FUNDS

As with the Basel Committee's large exposure framework, the FRB proposes the implementation of a 'look-through' requirement designed to capture the indirect exposures that a 'covered company' may have to the issuer of assets held within an investment fund structure. Under the proposed rule, a 'covered company' would be required to assess whether its credit exposure to the issuers of assets held in any such fund exceeds .25% of its Tier 1 capital, and to the extent that it does, to recognize an exposure to each of the underlying assets held within the fund. Should it be unable to do so, the 'covered company' would be required to

[23] 'Proposal for a Regulation of the European Parliament and of the Council on Money Market Funds,' European Commission (September 4, 2013).

aggregate the entire exposure to the investment fund structure to a single 'unknown counterparty', also subject to credit exposure limits. Unlike the Basel Committee, the FRB does not envision a 'partial look-through' approach, in which the 'covered company' is permitted to exclude exposures to assets held within an investment fund structure which represent less than .25% of its Tier 1 capital, even if the 'covered company' is unable to identify all of the underlying exposures within such a fund.

In the preamble to the proposed rule, the FRB states that the 'look-through' requirement applies to any investment fund structure in which 'the covered company invests or to which the covered company otherwise has a credit exposure.'[24] Similar language appears in Section 252.173 (b) of the rule text.[25] In Section 252.75, however, the FRB specifies that the 'look-through' requirement is meant to apply in cases where the 'covered company' invests in a 'securitization fund, investment fund or other special purpose vehicle'.[26] This more targeted approach is consistent with the standard adopted by the Basel Committee, which prescribes the 'look-through' requirement only in in cases where a bank invests in a fund structure with underlying investment assets.[27]

While it is unclear whether the FRB intended to deviate from the Basel Committee standard, we are concerned that the application of the 'look-through' requirement to any exposure that a 'covered company' may have to an investment fund structure is unworkable and would create highly anomalous outcomes which are inconsistent with the design and purpose of the SCCL framework. As an example, under this broad-based approach, a 'covered company' would be precluded from treating an investment fund structure as a 'counterparty' when entering into a normal course financial transaction with such a fund, including a swap transaction or a foreign currency forward, to the extent that the resulting exposure exceeds the prescribed *de minimus* threshold of .25% of Tier 1 capital. Similarly, this approach would also capture exposures which result from the servicing relationship that exists between a custody bank and its investment fund clients, such as overdrafts and other similar short-dated extensions of credit. Instead, in these and other similar instances, the 'covered company' would effectively be required to 'ignore' the legal structure of the investment fund and assume the presence of a direct credit exposure to all of the entity's assets even though the 'covered company' bears none of the underlying credit risk.

As such, we request clarification in the final rule that the 'look-through' requirement is only intended to apply in instances where the 'covered company' invests in an investment fund structure (*i.e.* a securitization fund, investment fund or other special purpose vehicle), rather than to the exposure of a 'covered company to an such fund more generally. If after due consideration of the issues raised, the FRB determines that the 'look-through' requirement is

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[24] FRB Notice of Proposed Rulemaking, page 57.
[25] FRB Notice of Proposed Rulemaking, page 130.
[26] FRB Notice of Proposed Rulemaking, pages 102-103.
[27] 'Supervisory Framework for Measuring and Controlling Large Exposures', Basel Committee on Banking Supervision (April 2014), paragraph 34, page 13.

nonetheless meant to apply to all credit exposures to an investment fund structure, we strongly recommend the introduction of an exemption for exposures to an investment fund client that result from the provision of traditional custody services, including payment, settlement and asset administration services.

As previously emphasized in our comment letter, custody banks such as State Street specialize in the provision of financial services to institutional investor clients such as pension funds, mutual funds, central banks, insurance companies and endowments. This centers on the safekeeping and administration of investment assets, and includes access to deposit accounts required to support day-to-day transactional activities. Essentially, custody banks provide the equivalent of checking accounts for institutional investors, used to buy or sell investment securities, along with the movement of cash resulting from these investment activities. This includes the execution of foreign currency transactions in financial markets where the client invests. Making it possible for clients to hold cash on deposit in various jurisdictions, and to be able to freely direct the movement of such cash, is therefore a central feature of the traditional custody function that should not trigger the imposition of a requirement to 'look through' to the institutional investor's underlying assets.

Global custody banks maintain robust systems to ensure the orderly processing of transactions within client investment accounts. This includes highly-integrated custody and accounting platforms, backed by operational policies and procedures adopted in accordance with national prudential regulation. This also includes systems to control the extent of possible credit exposure to the institutional investor client. While virtually all client transactions settle as expected, there are occasions where a transaction may be delayed or fail due to timing, matching, systems or other operational impediments. These typically arise due to unexpected matters, such as a missing or erroneous trade instruction, and are generally only apparent late in the business day when it is beyond the ability of the client to immediately eliminate or otherwise reduce the exposure. Although always short-dated, these extensions of credit can produce exposures that could easily surpass the *de minimus* threshold of .25% of Tier 1 capital, thereby potentially requiring custody banks to routinely 'look-through' to the underlying assets held by their institutional investor clients. This includes heavily regulated funds, such as US mutual funds, EU UCITS and other similar national equivalents.

We do not believe that this outcome is intended by the FRB, since these custody related exposures are incidental to the provision of a fee-based financial service, are not designed to generate yield from credit risk assets, and are offered in a manner which limits the scope of any potential credit risk to the 'covered company'. This includes limits which the custodian places on the size of any short-dated exposure to an investment fund linked to the value of the assets held in custody, and the *de facto* control which the custodian has over the investment fund's assets. In our view, the simplest and most direct way to structure an exemption from the 'look-through' requirement for exposures that result from the provision of traditional custody services to an investment fund client would be by reference to the presence of a Custody Service Level Agreement ("CSLA") or other similar equivalent, that governs day-to-day transactional activities within the client's account. Alternatively, the FRB may wish to consider an exemption based upon Subpart A, Section 4(b) (2) and 4(b) (3) of the joint-agency final rule on the Liquidity Coverage Ratio, which refers to 'an account designated as an operational account', used by a customer for the primary purpose of obtaining an operational service provided by the bank.'[28]

EXPOSURES RELATING TO THE PROVISION OF TRADITIONAL CUSTODY SERVICES

Using its authority under Section 165(e) (6) of the Dodd-Frank Act, the FRB proposes to exempt from the SCCL framework the intra-day credit exposures of a 'covered company' to a 'counterparty'. This is designed to 'help minimize the impact of the rule on the payment and settlement of transactions.'[29] While we strongly support this exemption and agree that the inclusion of intra-day credit exposures within the scope of the SCCL framework could have profoundly negative implications for the ability of 'covered companies' to support normal course payment, clearing and settlement activities, we believe that the proposed exemption is defined too narrowly and that it should be expanded to include short-dated exposures that result from the same transactional activities.

As previously emphasized in our comment letter, custody banks such as State Street play a key role in the day-to-day operation of the financial markets by facilitating payments and other movements of cash related to various transactional activities undertaken by their clients. This requires custody banks to maintain deposit accounts on behalf of their institutional investor clients and to provide temporary liquidity, extending for example, provisional credit to smooth timing differences between the settlement of a securities transaction and the movement of redemption proceeds, or providing overdraft protection to address a settlement delay or the non-receipt of funds. As such, custody banks play an important role in facilitating access to, and the smooth operation of, the financial markets. This is encouraged by supervisory authorities as a way of avoiding bottlenecks that would otherwise hamper market efficiency and exacerbate potential systemic risk. Although typically provided on an intra-day basis, there are occasions where it is necessary to extend credit on an overnight basis, or even over a period of several days.

This is recognized in the EU's implementation of the large exposure regime, where provisions are made to accommodate temporary extensions of credit related to day-to-day transactional activities in financial markets. More specifically, Article 390(6) of the Capital Requirements Regulation specifies that; 'exposures shall not include: (a) in the case of foreign exchange transactions, exposures incurred in the ordinary course of settlement during the <u>two working days</u> following payment; (b) in the case of transactions for the purchase or sale of securities, exposures incurred in the ordinary course of settlement during the <u>five working days</u> following

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[28] 'Liquidity Coverage Ratio: Liquidity Risk Measurement Standards,' Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System and Federal Deposit Insurance Corporation, Federal Register Volume 79, No. 197 (October 10, 2014).
[29] FRB Notice of Proposed Rulemaking, page 62.

payment or delivery of securities, whichever is earlier; (c) in the case of the provision of money transmission, including execution or payment services, clearing and settlement in any currency and correspondent banking, or financial instruments clearing, settlement and custody services to clients, delayed receipts in funding and other exposures arising from client activity which do not last longer than the following business day; (d) in the case of the provision of money transmission , including the execution of payment services, clearing and settlement in any currency and correspondent banking, intra-day exposures to institutions providing those services'.[30]

We strongly believe that a similar approach should be adopted by the FRB. Although almost always short-dated and subject to de facto collateralization by the fund's underlying assets held in custody, extensions of credit associated with day-to-day transactional activities can be large, especially in comparison to a 'covered company's' Tier 1 capital. Indeed, when combined with other exposures subject to the SCCL framework, these extensions of credit may cause a custody bank, such as State Street, to temporarily exceed the applicable credit exposure limit. Moreover, given the transactional nature of custody-related exposures, it is possible that aggregate exposures to a given counterparty may exceed the applicable credit exposure limit for a period of several days, even though the initial transaction causing the exposure has cleared, due to additional day-to-day transactional activities. As such, custody banks must have the ability to incur additional transactional exposures to a given counterparty when the applicable credit exposure limit is exceeded in order to ensure the continued seamless operation of payment, clearing and settlement systems.

We therefore strongly recommend that the FRB incorporate within the SCCL final rule, an exemption for short-dated exposures arising from the provision of traditional custody services that is consistent with the exemption contained in the EU large exposure regime, provided that:

- The 'covered company' has policies and procedures that govern the extension of credit to its clients under a fully executed CSLA, and that such exposures are monitored on a daily basis;
- The 'covered company' reports the exposure to its primary regulator not later than the first business day after the excess occurs, and until such time as the excess exposure is cleared; and
- The 'covered company' takes appropriate actions to reduce the excess exposure amounts within the timeframes permitted by the rule.

Alternatively, the FRB may wish to consider the implementation of a 'cure period' for short-dated exposures arising from the provision of traditional custody services that is based on the longest timeframe specified in the EU large exposure regime, or five business days, provided

[30] 'EU Regulation No. 575/2013 of the European Parliament and of the Council of 26 June 2013 on Prudential Requirements for Credit Institutions and Investment Firms and Amending Regulation EU No. 648/2012', CRR Article 390(6).

that the 'covered company' is permitted to execute additional transactions on behalf of its institutional investor clients during the 'cure period' if required to support normal course payment, clearing and settlement activities.

CONCLUSION

Thank you once again for the opportunity to comment on the important matters raised within this consultation. To summarize, while we strongly support the risk mitigation benefits of Section 165(e) of the Dodd-Frank Act and we welcome several of the changes made by the FRB to the originally proposed SCCL framework, we continue to have serious concerns relative to the impact of the rule on the custody bank business model, and therefore our ability to continue to provide seamless services to our clients. We therefore recommend a series of adjustments to the proposed rule designed to address certain limitations that would otherwise cause broad an unwarranted disruptions to our stable and highly-valued business model.

First, in order to improve risk-sensitivity and avoid the prospect of regulatory arbitrage, we recommend that the FRB adopt an approach for the measurement of exposures to agency-indemnified SFTs that is consistent with the intended approach for OTC derivatives transactions. More specifically, we recommend that 'covered companies' be permitted to make the use of their supervisory approved VaR Methodologies until such time as the Basel Committee finalizes, and the US prudential regulators adopt, the revised 'comprehensive approach' for SFTs as foreseen in the second consultation on revisions to the standardized approach for credit risk.

Second, in order to address possible ambiguities in the treatment of certain categories of investment funds, we recommend that the FRB revise the definition of a subsidiary in the proposed rule so that it is based on the control test for determining entities which must be aggregated to a 'counterparty' for purposes of the SCCL framework, rather than on Section 2(a) of the Bank Holding Company Act. Furthermore, we oppose the suggestion in Question 3 of the proposed rule that the SCCL framework should potentially be expanded to include 'any investment fund or vehicle advised or sponsored by a covered company'.[31]

Third, we recommend clarification that, consistent with the Basel Committee's large exposure regime, the requirement to 'look-through' to the issuer of assets held in an investment fund structure (*i.e.* a securitization fund, investment fund or other special purpose vehicle) , only applies in cases where the 'covered company' invests in such a fund, and that in any case this requirement does not extend to exposures that result from the provision of traditional custody services to an investment fund client.

[31] FRB Notice of Proposed Rulemaking, page 14.

Finally, we recommend the introduction of an exemption for short-dated dated exposures arising from the provision of traditional custody services that is consistent with the exemption contained in the EU large exposure regime, subject to certain additional requirements, or alternatively the implementation of a 'cure period' for such exposures that is based on the longest timeframe specified in the EU large exposure regime, or five business days.

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

Sincerely,

Stefan M. Gavell

ANNEX 1

Example of the Impact of the Amended Comprehensive Approach on the Measurement of Securities Lending Exposures

The risk of an individual security can be viewed, at a high-level, as a combination of an idiosyncratic risk component, plus a market risk component ($\alpha + \beta m$).

As an example, the combined risk of a main index equity lent and a main index equity received as collateral would therefore be ($\alpha 1 + \beta 1 m$) – ($\alpha 2 + \beta 2 m$), which equals the square root of $((\alpha 1)^2 + (-\alpha 2)^2 + 2(\alpha 1)(-\alpha 2)(\rho)) + (\beta 1 - \beta 2)m)$.

Taking conservative market-based assumptions the risk of such a combination would then be the square root of $((2.1)^2 + (-3.2)^2 * 2(2.1)(-3.2)(-1.00)) + ((.8 - .7) * 10.61)$ = ***5.36.***

The market-based assumptions are:

$\alpha 1 = 2.1\%$
$\alpha 2 = 3.2\%$
$\rho = -1.00$ (this is a most conservative estimate, thereby providing a worst case outcome)
$\beta 1 = .8$
$\beta 2 = .7$
$m = 10.61\%$

The proposed haircut-based methodology does not recognize the offsetting benefit of the βs and effectively adds them together, thereby deriving a significantly higher risk of the combined position (10.61+10.61) = ***21.22.***