

**Meeting Between Staff of the Federal Reserve Board and State Street
December 12, 2017**

Participants: Norah Barger, Steven Spurry, Constance Horsley, Peter Clifford, Phillip Weed (by phone), Christopher Powell, Marco Goncalves Migueis, Robert Motyka, Adam Cohen, Brian Chernoff (Federal Reserve Board)

Stefan Gavell, Robert McKeon, Joseph Barry, Adam Heilmann (State Street)

Summary: Staff of the Federal Reserve Board met with representatives of State Street to discuss the notice of proposed rulemaking to establish a Net Stable Funding Ratio requirement. State Street's representatives discussed the definition and treatment of operational deposits under the proposed rule.

Attachment

Policy Recommendations – US Liquidity Framework

December 12, 2017



Overview - Custody Banks and the US Liquidity Framework

The US Liquidity Framework is unnecessarily stringent in its treatment of custody banks

- Custody banks, such as State Street, specialize in the provision of safekeeping and asset administration services to institutional investor clients, such as pension funds, mutual funds and official institutions.
- These services, which require access to deposit accounts used to support day-to-day transactional activities, result in large amounts of stable deposits, which are used to fund the custody bank balance sheet.
 - As of September 30, 2017, client deposits accounted for 84% of our total liabilities.
- The treatment of custody deposits in the US liquidity framework is therefore of substantial importance to State Street and to our ability to fully meet our client's investment servicing needs.
- We support robust liquidity standards and believe that the US Agencies have implemented a framework for operational deposits and liquidity stress testing ("LST") which promote the prudent management of liquidity risk.
- However, the existing Liquidity Coverage Ratio ("LCR") rule and the proposed Net Stable Funding Ratio ("NSFR") rule prohibit deposits which result from the provision of custody services to a non-regulated fund from being treated as operational.
- In addition, the proposed NSFR rule uses an available stable funding ("ASF") factor for operational deposits which is substantially more conservative than the stability factor which results from supervisory mandated-LST.
- Without reasonable adjustments to the US liquidity framework, US custody banks such as State Street, will be placed at a commercial disadvantage relative to their non-US peers, and may be forced to constrain their custody and deposit-taking functions.

Operational Deposits and Non-Regulated Funds

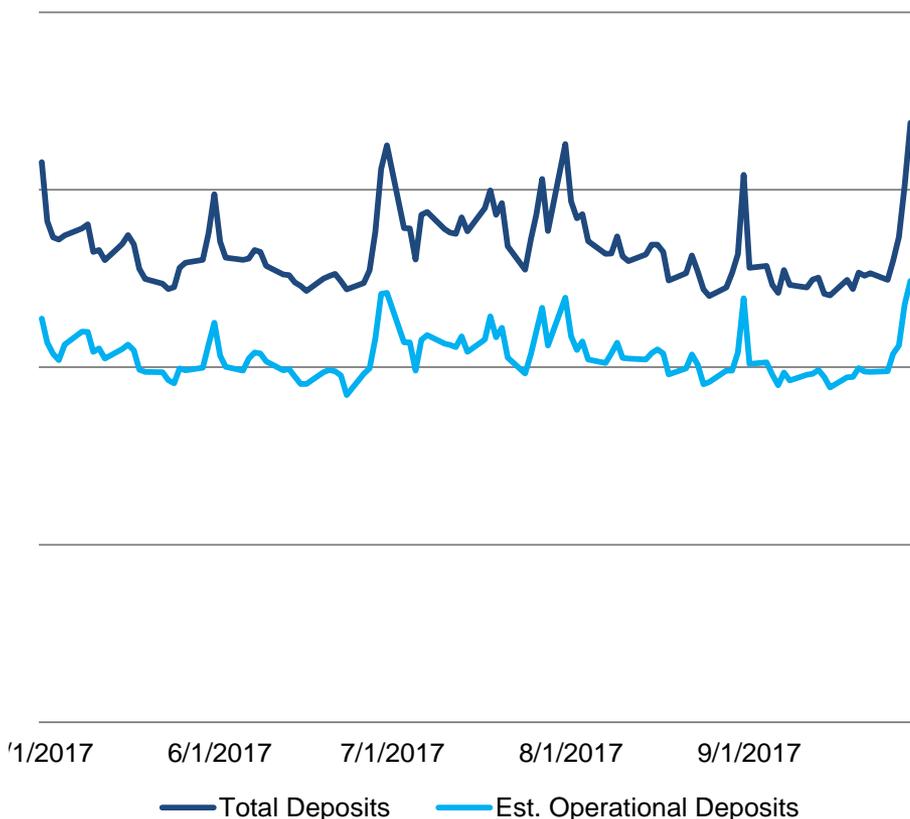
The US Liquidity Framework does not recognize operational deposits from non-regulated funds

- Under US rules, deposit balances that result from the provision of custody and other operational services to a non-regulated fund are excluded from categorization as an operational deposit.
- This restriction is specific to the US and has been implemented alongside the exclusion in the Basel III liquidity framework for deposit balances that result from the provision of prime brokerage services.
- The use of custodian banks by non-regulated funds has increased since the financial crisis as a way of reducing risk, and enhancing the safety of investment assets.
- Custody services are distinct from prime brokerage services (custodians do not facilitate or finance client trading activities) and include;
 - Access to the global settlement infrastructure in order to complete the purchase or sale of investment securities;
 - Various administrative services tied to investment assets, such as the processing of income and other interest payments, corporate action events, tax reclamations and client subscription and redemptions;
 - Access to deposit accounts in order to facilitate day-to-day transactional activities;
 - Ancillary services, such as fund administration, trustee services, investment analytics and regulatory reporting.
- Deposit balances that result from the provision of custody services to a non-regulated fund can readily be assessed using the same ‘operational deposit modeling processes’ used for a regulated investment fund.
- The use of a custodian bank to separate a non-regulated fund’s assets from its trading and financing activities enhances financial stability, and should be encouraged by the US Agencies.

Potential Operational Deposit Capture for Non-Regulated Funds

State Street's non-regulated fund client base has an operational deposit capture rate that is similar to the operational deposit capture rate for our total client base

Figure I – Potential Non-Regulated Fund Operational Deposit Composition



The figure on the left shows a back test of the operational deposit level generated from State Street's non-regulated fund clients in the period from May 1, 2017, to September 30, 2017.

This back test demonstrates an operational deposit capture rate for our non-regulated fund clients that is similar to the operational deposit capture rate for our total client base.

In both cases, State Street's operational deposit modeling processes identifies and excludes deposit balances that do not meet the prescribed qualification requirements (i.e. 'excess amounts').

The US Agencies should revise the existing LCR rule and the proposed NSFR rule to permit the recognition of custody deposits from non-regulated funds as operational.

Note: Non-regulated investment fund operational deposit levels for this analysis were calculated for the sole purpose of estimating their operational deposit potential, and were computed using State Street's payments based operational deposit methodology.

Calibration of the ASF Factor for Operational Deposits

The treatment of operational deposits in the NSFR is highly conservative

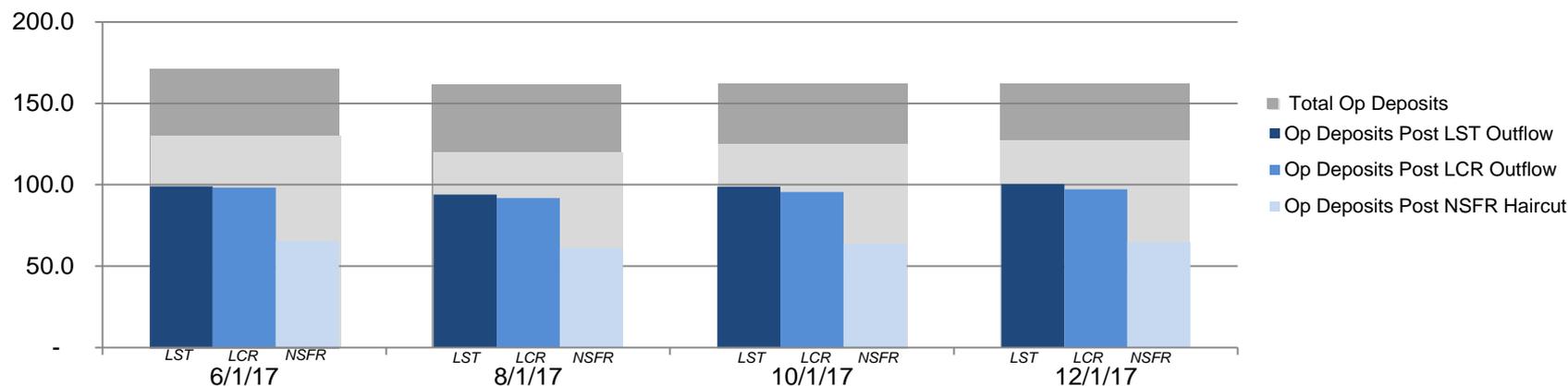
- Operational deposits face a number of requirements that do not generally apply to other types of liabilities:
 - Operational deposits are limited to deposits that result from the provision of ‘clearing, custody and cash management services’;
 - Operational deposits must meet a series of stringent qualification requirements; notably a firm must demonstrate that deposits are ‘empirically linked to the (underlying) operational service’ and that there is a methodology in place to identify and exclude ‘excess amounts’;
 - Operational deposits must be identified using data-driven ‘operational deposit modeling processes’, designed to identify deposit balances which are directly linked to each client’s day-to-day transactional needs .
- Large US banks, such as State Street, are also subject to the FRB’s annual ‘comprehensive liquidity assessment and review’ (“CLAR”) process, designed to assess the sufficiency of a firm’s liquidity risk management practices. Key to the CLAR process is a detailed review of the firm’s LST framework, and its accompanying operational deposit models.
- The US Agencies have therefore developed a framework for operational deposits that is extremely robust and which can be used to accurately gauge the presence of stable funding over both a short-term stressed (LCR) and a longer-term structural (NSFR) horizon.
- By combining this highly granular, empirically-based assessment of operational deposits with a risk-insensitive ASF factor of 50%, the US Agencies are proposing to implement a ‘gold-plated’ measure of structural funding, with outcomes that are substantially more restrictive than those derived from LST.

Operational Deposit Impact Comparison

NSFR requirements drive more severe impacts than LST, which is based on the same one-year horizon

- The figure below compares the impacts of LST and the NSFR on State Street’s operational deposits; our LST methodology classifies custody clients into discrete behavioral groups/ tiers based on the number of services provided, the criticality of those services, deposit volumes and insight from business units globally.
- While both liquidity measures use the same one-year time horizon, the NSFR is intended to reflect the stability of funding across all ‘market conditions’, whereas LST is based on a sustained period of financial stress.

Figure II – Operational Deposit Impact (Billions)



- The NSFR’s proposed 50% ASF factor produces outcomes which are significantly more severe than the outflow rate identified via our LST.
- The US Agencies should recalibrate the ASF factor for operational deposits to more closely align with the results of LST, or alternatively, they should pursue national discretion at the Basel Committee to set the ASF factor based on the results of LST in those jurisdictions with a suitably rigorous liquidity risk management framework.