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Office of the Secretariat
Financial Stability Board
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CH-4002, Basel
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Consultative Document: A Policy Framework for Addressing Shadow Banking Risks in Securities Lending and Repos

Dear Sir/Madam:

State Street Corporation (“State Street”) appreciates the opportunity to comment on the Policy Framework for Addressing Shadow Banking Risks in Securities Lending and Repos (“Policy Framework”) issued by the Financial Stability Board (“FSB”). The Policy Framework is designed to address potential financial stability issues in the securities lending and repo markets, and comprises three areas of focus: enhanced transparency, regulation of financial activities and improvements in market structure.

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 U.S. financial holding company, with operations conducted through several entities, primarily its wholly-owned bank subsidiary, State Street Bank and Trust Company. We are a major provider of agency securities lending services on behalf of our institutional investor clients, a financial activity that is subject to well-defined and stringent prudential supervision.

¹ As of September 30, 2012.

State Street has worked with various industry groups, including the Committee on Securities Lending of the Risk Management Association (“RMA”) and the International Securities Lending Association (“ISLA”), in an assessment of the proposed Policy Framework. We wish to emphasize, in this respect, our broad support for the recommendations made by these industry associations to both improve and clarify the FSB’s intended approach. In addition, we would like to offer the following high-level observations.

OVERVIEW

State Street welcomes the FSB’s acknowledgment of the important benefits of securities lending and repos in the efficient functioning of financial markets. This includes their role in support of market making and hedging activities, the timely settlement of securities transactions, enhanced price discovery and improved market liquidity. State Street also strongly supports the FSB’s recognition of the need, in framing its policies, to distinguish between securities lending and repo activities associated with market financing from those activities associated with the lending or borrowing of individual securities, or what is generally referred to as demand-driven activities. Historically, agency securities lending activities have primarily been driven by demand for individual securities, as opposed to market financing.

We commend the FSB for acknowledging the differences which exist in the conduct of securities lending and repo activities by prudentially regulated banks vs. non-banks. Custody banks, such as State Street, have long provided agency securities lending services to their institutional investor clients under the careful supervision of prudential authorities. This includes the comprehensive assessment and management of risk, backed by specific credit concentration, capital and leverage requirements. These measures have been further enhanced by a series of regulatory reform initiatives, such as the Basel III capital and liquidity accords and in the U.S., the single counterparty credit concentration limits of Section 165 of the Dodd-Frank Act. As such, it would be inappropriate to subject prudentially regulated banks to additional policy measures that may otherwise be suitable for the activities of non-banks.

In our estimation, any new regulatory measures should focus on addressing regulatory gaps, an approach that requires a careful assessment of potential overlap in regulation, such as the simultaneous and potentially conflicting imposition of risk-based capital and haircut requirements. When regulatory gaps are identified, they should be filled with appropriate and carefully tailored countermeasures rather than on the basis of an overly prescriptive ‘one-size fits all’ approach. This may at times include non-prudential measures, such as enhanced disclosure requirements and client suitability standards. We strongly support the development of globally consistent principles for securities lending and repo activities, designed to reduce unnecessary complexity, avoid regulatory arbitrage and facilitate the comprehensive assessment of risk. This is especially true of data reporting, credit concentration, capital and liquidity requirements.

TRANSPARENCY

State Street acknowledges the importance of improved transparency in the securities lending and repo markets. This includes supervisory access to data designed to facilitate the monitoring of potential systemic risks and enhanced investor disclosure to ensure informed decision-making. Still, we believe that not all data has equal value and that care should be taken to create a reporting framework that is fit for purpose and as closely aligned with industry practice as possible. We note, in this respect, that the introduction of trade repositories for the reporting of transaction-level data may not be the most productive approach, and that a more meaningful outcome may be achieved via enhancements to prevailing position or exposure-based reporting requirements. This reflects, among others, the significant anticipated cost of a transaction-by-transaction based solution, its broad operational, technical and analytical complexities, and its divergence from current risk-based practices.

Similarly, we also note that corporate disclosures provided through financial statements and other regulatory filings serve a very specific set of accounting, business and legal purposes, and are generally not well-adapted to the monitoring of systemic risk. Moreover, the scope of the envisioned disclosures are extensive, requiring the release of information on counterparty concentration, composition of securities lending portfolios including collateral received, maturity breakdown of transactions, information on collateral margins and extent of collateral reuse, credit risk exposures, and other significant qualitative information. We therefore have important reservations regarding the FSB's recommendations, particularly in view of possible forthcoming modifications to accounting standards. Furthermore, we note the importance of adhering to existing materiality principles in corporate accounting, and avoiding the development of excessively granular disclosures that may simply serve to confuse the target audience. As such, we recommend careful additional scrutiny of the need for and scope of potential changes to corporate disclosure requirements, with the broad input of appropriate national authorities, standard setting bodies and industry associations.

REGULATION

State Street supports the use of robust standards in the methodologies used by market participants for the measurement of their exposure to securities lending and repo transactions. This includes appropriately calibrated collateral haircuts. Banks that are active in the securities lending market, including custody banks with large agency lending programs, typically use supervisory approved value at risk ("VaR") methodologies to assess and manage their credit exposures. These models have evolved over time based on accumulated industry and supervisory expertise, while also benefiting from ongoing, detailed regulatory scrutiny. VaR models have proven effective in the measurement of risk, including in periods of financial market instability, as validated by back-testing and other risk controls. We therefore believe that the agency securities lending industry already broadly meets the recommendations specified in Section 3.1.2 of the FSB Policy Framework.

While we acknowledge the concerns raised by the FSB relative to pro-cyclicality and the development of excessive leverage in the financial system, we have serious reservations regarding the implications of binding numerical floors on collateral haircuts in the securities lending and repo markets. As an initial matter, we question the appropriateness of measures that would seek to dictate the negotiated terms of market transactions, especially transactions between regulated counterparties. In addition, we note the broad imprecision inherent in binding numerical floors and therefore the potential dramatic overstatement of risk. Among the most significant structural limitation of numerical floors is their failure to account for the correlation which exists between securities lent and securities received. They therefore serve as a far less accurate measure of risk than well-established supervisory approved VaR models.

We therefore strongly oppose the introduction of mandatory haircuts in the securities lending and repo markets, particularly in the context of activities which are not designed for the purpose of market financing. As an alternative, the FSB may wish to promote the general principle that the risks of securities lending and repo transactions must be appropriately taken into account by all market participants, whether in or outside of the traditional banking system. This would avoid a ‘one-size fits all’ approach and enable market participants that are subject to different regulatory regimes to maintain suitable risk management processes. In terms of potential pro-cyclicality, we believe that this can most effectively be addressed through appropriate risk-based limits on capital, leverage and liquidity.

State Street supports the use of robust standards in cash collateral reinvestment programs, designed to ensure the proper identification and management of risk. This includes the development of comprehensive cash collateral reinvestment guidelines for each lender and the use of target concentration ratios. Still, we note that there are important differences in the securities portfolios and risk tolerance of individual lenders. Moreover, the liquidity profiles of collateral reinvestment pools tend to differ significantly from those of other short-term cash investment vehicles. This reflects the reality that collateral reinvestment pools are designed to support securities lending transactions rather than for short-term cash management needs. Also, they are used to hold cash collateral for multiple individual transactions and operate on the basis of cross-collateralization. The potential for sudden draw-downs in collateral reinvestment pools is therefore limited, even during periods of financial market instability. We therefore caution against the imposition of any ‘one size fits all’ approach to the regulation of cash collateral reinvestment programs, such as the introduction of blanket weighted average life (“WAL”) or weighted average maturity (“WAM”) requirements.

MARKET STRUCTURE

Consistent with the views of the FSB, we agree that there is no compelling reason for regulatory or other policy action to impose centralized clearing on the securities lending and repo markets. While it may be appropriate for certain segments of the market with significant levels of offsetting transactions, such as inter-dealer repos, to move towards a more centralized clearing model, there are sufficient market incentives in place for the industry to evolve as required. We note, in this respect, that centralized clearing has not to date emerged in the context of agency

securities lending activities based on a rational industry-wide assessment of its relative costs and benefits, along with insufficient volumes of standardized transactions. It would therefore be inappropriate for supervisory authorities to seek to compel the adoption of a clearing requirement for the agency securities lending and repo markets generally, without a definitive and well-articulated risk-based rationale.

CONCLUSION

Thank you once again for the opportunity to comment on the several important matters raised within the proposed Policy Framework. To summarize, State Street has worked with industry associations in the assessment of the FSB's intended approach and broadly supports the recommendations made by among others, the RMA and ISLA.

We welcome the FSB's acknowledgment of the benefits of securities lending and repos to financial markets, the distinction drawn between market financing and demand-driven transactions and the recognition of the differences which exist between the financial activities of prudentially regulated banks vs. non-banks. We believe that further regulatory measures should carefully target identified regulatory gaps, and support the development of globally consistent principles.

We acknowledge the importance of greater transparency in the securities lending and repo markets, but emphasize the need for a balanced and proportionate data framework. This includes a preference for position or exposure-based reporting rather than transaction-based reporting via trade repositories. This also includes a more careful assessment of the necessity for and scope of potential changes in corporate disclosure requirements.

We believe that banks active in the agency securities lending market already meet appropriate risk management standards, and have strong reservations regarding the suitability of mandatory collateral haircuts, especially in the context of demand-driven transactions. We support the use of robust cash collateral reinvestment standards, but caution against the imposition of a 'one size fits all' approach. We support industry led efforts to further improve the structure of the securities lending and repo markets and agree that there is no compelling need for specific regulatory intervention at this time.

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