BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D.C. 20551

DIVISION OF BANKING
SUPERVISION AND
REGULATION

August 15, 2006

Gregory J. Lyons
Goodwin Procter LLP
Exchange Place
Boston, MA 02109

Dear Mr. Lyons:

This is in response to your letter dated June 19, 2006 ("the request") on behalf of State Street Corporation ("SSC"), Boston, Massachusetts, and its wholly owned subsidiary, State Street Bank and Trust Company ("State Street"), Boston, Massachusetts, with regard to the regulatory capital treatment of certain securities lending transactions. In these transactions, State Street, acting as agent for clients, lends its clients' securities and receives liquid securities collateral in return (the "securities collateral transactions").[1] Each securities loan is marked-to-market daily, and State Street calls for additional margin as needed to maintain a positive margin of collateral relative to the market value of the securities lent at all times. State Street also agrees to indemnify its clients against the risk that, in the event of borrower default, the market value of the securities collateral is insufficient to repurchase the amount of securities lent.

The request states that if the borrower were to default, State Street would be in a position to terminate a securities collateral transaction and sell the collateral in order to purchase securities to replace the securities that were originally lent. Thus, State Street's exposure under a securities collateral transaction is limited to the difference between the purchase price of the replacement securities and the market value of the securities collateral.

The Federal Reserve Board's risk-based capital guidelines ("the guidelines") treat indemnifications issued in connection with agency securities lending activities as off-balance sheet guarantees that must be converted at 100 percent to an on-balance sheet

[1] The liquid securities collateral includes government agency, government-sponsored entity, corporate debt or equity, or asset-backed or mortgage-backed securities.

asset (12 CFR parts 208 and 225, App. A, § III.D.1.c.). The resulting asset is then assigned to the lower of the risk-weight category appropriate to the counterparty or the collateral (12 CFR parts 208 and 225, App. A, § III.C.). Accordingly, the indemnity provided by State Street under the securities collateral transactions would qualify for a 0 percent risk weight if it were fully collateralized by cash or OECD government securities. The indemnity would receive a 20 percent risk weight if State Street's counterparty were an OECD bank or a qualifying securities firm, or if the collateral were composed of securities issued or guaranteed by U.S. government-sponsored enterprises. If, however, the securities collateral transactions were collateralized by corporate debt or equity securities and were entered into with counterparties that are not OECD banks or qualifying securities firms, the resulting asset generally would be risk-weighted at 100 percent.

In the request, you ask that SSC and State Street receive a risk-based capital treatment for the securities collateral transactions similar to that which the Federal Reserve Board ("the Board") extended to State Street in a letter dated May 14, 2003 ("the prior approval") for transactions in which State Street, acting as agent for clients, lends its clients' securities and receives cash collateral in return, then reinvests the cash collateral in a reverse repurchase agreement and receives securities collateral in return. In the transactions subject to the prior approval (the "cash collateral transactions"), State Street indemnifies its client against the risk of default by the securities borrower and the risk of default by the reverse repurchase counterparty.

In support of the request, you note that the current capital treatment for securities collateral transactions results in a capital requirement that does not accurately reflect the actual risk involved in such transactions. You also argue that the securities collateral transactions are economically equivalent to the cash collateral transactions for which the Board granted relief in the prior approval. In both cases, State Street, as agent, indemnifies its client against counterparty default and effectively holds securities as collateral against the obligations of the counterparty. You further argue that the securities collateral transactions generally present less operational risk to State Street than the cash collateral transactions because of the reduced number of contractual arrangements required in the securities collateral transactions.

In addition, you highlight that the current U.S. bank regulatory capital treatment for the securities collateral transactions gives rise to competitive equity issues, given that both foreign banks and U.S. non-bank securities lenders generally incur a lower regulatory capital requirement for these transactions than U.S. banks. You underscore the competitive benefits of greater collateral flexibility by stating that the primary growth areas for State Street's securities lending business are Europe, Asia and Canada, all of which are predominantly non-cash collateral markets. Furthermore, you indicate that engaging in securities collateral transactions provides income diversification for State Street because income through these transactions is fee-based whereas cash collateral transactions are based on interest rate spreads.

Under the treatment outlined in the prior approval for cash collateral transactions, State Street is required to determine an unsecured loan equivalent amount for each of the

counterparties to which State Street, as indemnifying agent, lends securities collateralized by cash and/or lends cash collateralized by securities. The unsecured loan equivalent amount is determined as the sum of the current exposure to the counterparty and a measure for potential future exposure ("PFE") to the counterparty. The current exposure is the sum of the market values of all securities and cash lent to the counterparty under State Street's indemnified arrangements, less the sum of the market values of all securities and cash received from the counterparty as collateral under the indemnified arrangements. The PFE calculation is based on the market volatilities of the securities lent and the securities received, as well as any foreign exchange rate volatilities associated with any cash or securities lent or received. The unsecured loan equivalent amount, determined as described above, is then assigned a risk weight appropriate to the counterparty for risk-based capital purposes.

The prior approval permits State Street to use a value-at-risk ("VaR") model for incorporating estimates of market volatilities into the calculation of PFE for each counterparty. Use of a VaR model allows State Street to take into account correlation of market price volatilities among the instruments it lends, as agent, to a counterparty and among the instruments it, as agent, takes as collateral from a counterparty, as well as correlations between the instruments lent to, and received as collateral from, the counterparty. The prior approval noted that State Street would be required to calculate daily an unsecured loan equivalent amount, including the VaR PFE component.

In the request you ask that the Board approve an exception to the guidelines by permitting State Street to measure exposure amounts for risk-based capital purposes with respect to the securities collateral transactions under the methodology of the prior approval.

After consideration of the request and subject to certain conditions listed below, the Board approves an exception to the guidelines that permits SSC and State Street to treat the securities collateral transactions described in the request in a manner that differs from that set forth in the guidelines. More specifically, the Board grants the request of SSC and State Street to use an unsecured loan equivalent amount (calculated as current exposure plus a VaR-modeled PFE) for the securities collateral transactions referenced above for risk-based capital purposes. The Board approves this exception under the reservation of authority provision contained in the guidelines. This provision permits the Board, on a case-by-case basis, to determine the appropriate risk weight for any asset or off-balance sheet item that imposes risks on a state member bank or bank holding company that are incommensurate with the risk weight otherwise specified in the guidelines (12 CFR parts 208 and 225, App. A, § III.A.).

As with the prior approval, State Street must calculate the VaR PFE component using a five-business-day holding period and a 99th percentile one-tailed confidence interval based on market price data over a one-year historical observation period. The data set used should be updated no less frequently than quarterly and should be reassessed whenever market prices are subject to material changes. For each counterparty, State Street will be required to calculate daily an unsecured loan equivalent amount, including the VaR PFE component. These calculations will be subject to supervisory review to

ensure they are in line with the quarter-end calculations used to determine regulatory capital requirements.

To qualify for the capital treatment outlined above, the securities collateral transactions covered by State Street's indemnification must meet the following conditions:

1. The transactions are fully collateralized;
2. Any securities lent or taken as collateral are eligible for inclusion in the trading book and are liquid and readily marketable;
3. Any securities lent or taken as collateral are marked-to-market daily; and
4. The transactions are subject to a daily margin maintenance requirement.

Further, the transactions must be executed under a bilateral netting agreement, or an equivalent arrangement. These arrangements must:

1. Provide the non-defaulting party the right to terminate and close-out promptly all transactions under the agreement upon an event of default, including in the event of insolvency or bankruptcy of the counterparty;
2. Provide for the netting of gains and losses on transactions (including the value of any collateral) terminated and closed out under the agreement so that a single net amount is owed by one party to the other;
3. Allow for the prompt liquidation or setoff of collateral upon the occurrence of an event of default;
4. Be, together with the rights arising from the provisions required in 1) to 3) above, conducted under documentation that is legally binding on all parties and legally enforceable in each relevant jurisdiction upon the occurrence of an event of default and regardless of the counterparty's insolvency or bankruptcy; and
5. Be conducted under documentation for which State Street has completed sufficient legal review to verify it meets provision 4) above and for which State Street has a well-founded legal basis for reaching this conclusion.

State Street currently has a VaR model that has been approved for purposes of the Board's market risk capital rule (12 CFR parts 208 and 225, App. E). The Board has determined that State Street will be permitted to use its VaR model to determine the PFE for each of the securities collateral transaction counterparties, subject to ongoing supervisory review of the model. State Street must conduct regular and rigorous backtesting procedures, which will be subject to supervisory review, on the counterparty VaR model the firm uses to ensure the validity of the correlation factors employed in the model and the stability of these factors over time. The counterparty VaR model will not be subject to a formal backtesting procedure at this time. If supervisory review indicates that State Street's counterparty VaR model or its backtesting procedures have material deficiencies and State Street does not take appropriate and expeditious steps to rectify those deficiencies, however, the Federal Reserve may take actions to adjust State Street's capital calculations. These actions could range from imposing a multiplier on the VaR estimates of PFE calculated by State Street to disallowing the use of its counterparty VaR

model and requiring use of a simpler, more conservative, own estimates approach to determine the PFE component of the unsecured loan equivalent amounts.

The Board believes that the capital treatment approved above for the securities collateral transactions provides a more risk-sensitive treatment for these transactions than that set forth under the guidelines. Moreover, the capital treatment approved for State Street in this letter is more consistent with best market practices and provides positive incentives for State Street to manage collateral actively and prudently. State Street should, however, be aware that the Board may in the future impose a regulatory capital treatment for these transactions that differs from the treatment described in this letter, depending in part upon the outcome of the current efforts to implement Basel II in the United States.

This determination is conditioned on State Street's compliance with all the commitments and representations it has made in connection with the request. These commitments and representations are deemed to be conditions imposed in writing by the Board in connection with granting the request and, as such, may be enforced in proceedings under applicable law. Further, this determination is based on the specific facts and circumstances described in the request and on discussions with Federal Reserve staff. Any material change in those facts and circumstances or any failure by State Street to observe any of its commitments or representations may result in a different view or in a revocation of the regulatory capital treatment permitted under this determination.

The capital treatment set forth in this letter for these transactions will be made available to similarly situated institutions that request and receive Board approval for such treatment.

If you have any questions with regard to this letter, please direct them to Norah Barger, Associate Director in the Division of Banking Supervision and Regulation, at (202) 452-2402, Juan C. Climent, Supervisory Financial Analyst in the Division of Banking Supervision and Regulation, at (202) 872-7526, or Mark Van Der Weide, Senior Counsel in the Legal Division, at (202) 452-2263.

Sincerely yours,

(signed)

William G. Spaniel
Acting Director