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Office of the Comptroller of the Currency
250 E Street, SW., Mail Stop 1-5,
Washington, DC 20219
Docket Number 06-15
Docket Number 06-09
regs.comments@occ.treas.gov

Jennifer J. Johnson, Secretary
Board of Governors of the
Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551
Docket Number No. R-1238
Docket Number No. R-1261
regs.comments@federalreserve.gov

Robert E. Feldman
Executive Secretary
Attn: Comments/Legal ESS
Federal Deposit Insurance Corporation
550 17th Street, NW
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Regulation Comments
Chief Counsel's Office
Office of Thrift Supervision
1700 G Street, NW
Washington, DC 20552
Docket Number 2006-49
Docket Number 2006-33
regs.comments@ots.treas.gov

Dear Sir or Madam:

State Street Corporation appreciates the opportunity to comment on the proposed U.S. implementation of the "International Convergence of Capital Measurement and Capital Standards: A Revised Framework" (the "New Accord" or "Basel II") as described by the Notice of Proposed Rulemaking (the "NPR") published by the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of Thrift Management (collectively, "the Agencies") on September 25, 2006.

Headquartered in Boston, Massachusetts, State Street specializes in providing institutional investors with products and services related to investment servicing, investment management and investment research and trading. With $11.9 trillion in assets under custody and $1.7 trillion in assets under management as of December 31st, 2006, State Street operates in 26 countries and more than 100 markets worldwide. As a global institution, we expect to be required to comply with the Basel II in numerous markets, including the U.S., Germany, Japan, Canada, Luxembourg, the United

Kingdom, and France. State Street would be designated a "core bank" under the NPR issued by the Agencies.

Overall, State Street believes the New Accord, if appropriately implemented, will result in a more risk-sensitive, consistent, and transparent system for bank regulatory capital. While we urge the Agencies to conclude the rule-making process as expeditiously as possible, we appreciate the Agencies' willingness to consider the views of the U.S. banking industry in the implementation of Basel II.

The proposed U.S. implementation of the New Accord described in the NPR creates considerable divergences between the U.S. regulatory capital system and those of other Basel II jurisdictions. We believe these disparities may erode the benefits of Basel II, create competitive challenges for U.S. banks, reduce transparency and comparability between regulatory jurisdictions, introduce unnecessary complexity, and substantially increase banks' cost of implementation and compliance burden.

Our comments below fall into two categories: general comments on the overall structure and qualification process for the Agencies' approach, and more specific comments on several types of exposures of importance to State Street.

General Comments

Phased Implementation and Additional Basel II Approaches

State Street strongly urges the Agencies to revise the NPR to provide for phased implementation and qualification of the advanced approaches for both credit and operational risk. In addition, we urge the Agencies to allow U.S. banks the choice of the full range of options for determining the capital requirements for both credit and operational risk provided in the New Accord.

Under the New Accord, banks are provided the choice of several risk-based capital calculation methodologies for both credit and operational risk. Banks choosing less sophisticated methodologies accept more conservative, less risk-sensitive capital calculations in exchange for a lower cost and compliance burden. In some cases, depending on the business and risk profile of an institution, permanent use of the less sophisticated approaches may be appropriate. In other cases, use of the less sophisticated approaches is a "stepping-stone" to the more sophisticated approaches, allowing banks to derive some of the benefits of Basel II while they complete the work necessary to adopt the advanced approaches.

Unlike the New Accord, the U.S. approach makes use of the A-IRB and AMA mandatory approaches for both core and opt-in banks, for essentially all portfolios and business lines. This "all-or-nothing" approach is particularly challenging for core banks, which are not provided the option of remaining under the U.S. general risk-based capital rules (Basel I).

We support providing the full range of Basel II approaches to U.S. banks, for both credit and operational risk. U.S. banks should be permitted to choose the combination of

Basel II approaches that best suits their business model. By doing so, the Agencies will more closely align the U.S. implementation with the New Accord, and adopt the incentive-based approach to regulatory capital negotiated by the Agencies and other global regulators through the Basel II process.

Providing U.S. banks access to additional approaches for both credit and operational risk would also facilitate the adoption of a phased approach to implementation and qualification for the advanced approaches, as provided in the New Accord.

Under the New Accord, for credit risk, banks would be allowed to adopt a "phased roll-out" of the IRB approach, either by asset class or business line. As discussed in the New Accord, the Basel Committee recognizes "that for many banks, it may not be practicable for various reasons to implement the IRB approach across all material assets classes and business units at one time." While a bank adopting the IRB would still be expected to ultimately use the IRB for all material asset classes and business units, the New Accord provides a process for a "roll-out" that allows use of the IRB in some asset classes or business units while a bank uses, on a transitional basis, less sophisticated approaches for other asset classes or business units. We suggest the Agencies adopt a similar concept for U.S. implementation.

In addition, we urge the Agencies to adopt the treatment contained in the New Accord for immaterial exposures. Under the New Accord, "exposures in non-significant business units as well as asset classes … that are immaterial in terms of size and perceived risk profile" could, with supervisory approval, be excepted permanently from the IRB. The New Accord makes clear that a supervisor may require additional capital to be held for these portfolios through Pillar II. The NPR is more restrictive in this area, requiring any excluded business lines, portfolios, and exposures to be immaterial, in the aggregate, to the bank. We believe the proposed U.S. approach is unnecessarily restrictive, and could lead to additional compliance cost with little or no risk management benefit, and we urge the Agencies to adopt the approach provided in the New Accord.

For operational risk, we again support the additional flexibility included in the New Accord, which provides for "partial use" of the AMA, with approval by the supervisor. Similar to the "phased rollout" for credit risk, the New Accord allows banks to use the AMA for some parts of its operations and the Basic Indicator or Standardized Approach for others, provided certain conditions are met, including a condition that the bank provides the supervisor a plan specifying the timetable to which it intends to roll out the AMA across all but an immaterial part of its operations. We encourage the Agencies to provide a similar process for U.S. implementation of Basel II.

In summary, we believe the adoption of a more flexible, phased approach to qualification for the advanced approaches will reduce implementation costs for U.S. banks, accelerate U.S. banks' ability to qualify for the advanced approaches for their most significant portfolios or business lines, and mitigate, to some extent, the competitive disadvantage created by delays in U.S. implementation of Basel II.

Non-risk sensitive constraints

As noted above, we support Basel II due to the benefits of increased risk-sensitivity for regulatory capital requirements. We are, however, concerned that numerous aspects of the NPR introduce arbitrary, non-risk sensitive elements to the regulatory capital system. These non-risk sensitive constraints include the NPR's overly conservative transitional floors, the proposed trigger to revise the U.S. implementation if aggregate capital declines by more than 10%, and the retention of the Tier 1 leverage ratio.

While each of these factors undermines the risk sensitivity of the NPR, for State Street, retention of the Tier 1 leverage ratio raises the most concern. Despite the substantial investments we are making to implement highly sophisticated risk measurement and management techniques, the relatively crude capital adequacy measure provided by the leverage ratio may continue to function as our de facto minimum regulatory capital standard, substantially reducing the value of our investment in more advanced methodologies. The U.S. is one of very few countries that requires compliance with a leverage ratio. We strongly urge the elimination of the leverage ratio, at least for banks that have qualified for the advanced Basel II approaches.

For numerous reasons, each of these arbitrary constraints is unnecessary. First, most U.S. banks maintain capital ratios in excess of the minimum requirements. Second, the prompt corrective action regime, which the Agencies plan to retain, gives supervisors significant tools to address emerging problems with a bank's capital levels. Third, Pillar II provides supervisors the ability to require additional capital, on a case-by-case basis. Finally, market forces, including rating agencies, place considerable importance on capital adequacy, and are an important factor in most banks' decision to maintain capital levels higher than the required regulatory minimums.

Other Inconsistencies with the International Agreement

In addition to the issues raised above, we are concerned by the numerous other inconsistencies between the NPR and the New Accord. While we do not necessarily have substantive issues with all of these differences, the overall level of inconsistency with the New Accord is a significant source of higher cost, complexity and compliance burden for U.S. institutions operating on a global basis, under a multitude of regulatory authorities.

For a global bank based in the U.S., these divergences from the New Accord will result in several challenges. First, despite the potential benefits of increased risk sensitivity, many U.S. banks will be hesitant to incur the additional complexity and expense of creating duplicative systems to comply with the IRB and AMA qualification processes in other jurisdictions. Second, the proposed unique U.S. system will create competitive disadvantage for U.S. banks compared to non-U.S. banks. U.S. banks will be required to apply the more conservative U.S. approach on a consolidated basis, while non-U.S. banks will only be required to use the more conservative U.S. rules for their U.S. bank subsidiaries. The result will be a more conservative minimum capital requirement for U.S. banks than their foreign competitors.

While we understand that the New Accord itself provides opportunity for national discretion, and don't disagree that such discretion may be appropriate in some cases, we believe U.S. banks will be best served by minimizing divergence from the New Accord, and we urge the Agencies to adjust the NPR accordingly.

Operational Risk

With the adoption of the AMA in the New Accord, and the continuing evolution of operational risk measurement and modeling techniques, State Street agrees that a Pillar I capital requirement for operational risk is feasible, and is an important element in a comprehensive risk management approach. As noted above, however, we suggest the Agencies provide U.S. banks the option of adopting any of the Basel II approaches for the measurement of operational risk, and adopt a qualification process that allows for "partial use" of the AMA as a transitional step towards the full advanced approaches.

While we support the AMA, we urge the Agencies to adopt an AMA approach with sufficient flexibility to reflect the current state of operational risk modeling. As Governor Bies commented in May 2005, there are many challenges to measuring operational risk, requiring the designers of operational risk measurement frameworks to "be more innovative, take bigger steps into new territory, and be more willing to step away from traditional --- and comfortably familiar --- techniques than their counterparts in the market- and credit-risk arenas."

We agree with Governor Bies' assessment, and therefore caution the Agencies to avoid adopting an overly prescriptive approach to approving banks' operational risk modeling techniques. Given the evolving nature of operational risk modeling, and lack of industry consensus to date on standard or best practices, we urge the Agencies to adopt a flexible approach to approving operational risk internal models.

Parallel Run Qualification Process

State Street requests greater flexibility in the supervisory process contemplated by the Agencies for approval to begin the parallel run period. We are concerned that the NPR appears to indicate that the parallel run period can only begin when a supervisor determines that a bank is fully compliant with all of the qualification requirements for the A-IRB and the AMA.

We agree that a bank entering the parallel run period should substantially meet the requirements the advanced approaches. However, we suggest the Agencies provide the flexibility to permit commencement of a parallel run period which allows some activities, as identified in a formal Board-of-Directors approved implementation plan, to be completed during the parallel run. Such activities could include continuing model validation and related documentation, phasing-in of advanced Basel II treatments for certain exposure portfolios, other documentation processes, and other similar activities.

We believe such an approach could take advantage of the parallel run period as an opportunity for continued evolution and improvement of a bank's A-IRB and AMA processes and techniques, and result in a more efficient qualification process.

Timeframe for Mergers and Acquisitions

The NPR establishes a timeframe for integration of an acquired institution into the acquiring institution's advanced approaches of 24 months, extendable by up to 12 additional months at the discretion of an institution's primary Federal supervisor. We believe this timeline to be reasonable.

We are concerned, however, with the Agencies' associated proposal to provide only 30 days following the closure of the transaction for the acquiring institution to submit an implementation plan to its primary supervisor outlining how it will incorporate the acquired institution into its advanced approaches. Given the considerably longer timeframe for actual integration, and the ability to use the acquired bank's existing regulatory capital calculation systems in the interim, we believe the 30 day requirement for submitting a complete implementation plan is unreasonable, and should be extended to a minimum of 180 days.

Pillar III Disclosure and Regulatory Reporting

As in other areas of the Agencies' proposal, our concerns with the Pillar III disclosure requirements relate primarily to inconsistencies between the NPR and the New Accord, and the resulting increase in compliance burden.

First, we believe the semi-annual disclosure required by the New Accord is sufficient, compared to the quarterly Pillar III disclosures required by the NPR, especially given the additional requirement to provide additional disclosures between reporting periods for any significant or material changes, and the complimentary quarterly disclosures by banks through the regulatory reporting system and SEC filings.

Second, given the lack of consensus between regulators, rating agencies, the accounting profession, accounting standard setting organizations, and banks related to many of these disclosures, we suggest the Agencies consider a phased approach to establishing Pillar III disclosure requirements, under which only a portion of the information discussed in the NPR is disclosed immediately, with disclosure requirements increasing as consensus between interested parties is reached on the nature of the disclosures and any associated issues, such as audit and certification requirements.

Third, regardless of the frequency of disclosures, the numerous differences between the NPR and the New Accord create additional compliance and competitive challenges, and reduce the likely effectiveness of Pillar III. Since many of the differences between the NPR and the New Accord (e.g. definition of default, LGD vs. ELGD, etc.) will lead to different calculations of risk-weighted assets, public disclosures issued by U.S. banks will not be directly comparable with those issued by non-U.S. banks. We suggest the Agencies address this issue by more closely aligning the U.S. implementation with the New Accord.

Fourth, with regard to one specific area of U.S. implementation, we suggest the Agencies time the disclosures associated with the new Market Risk Amendments to coincide with the disclosures associated with Basel II. Establishing a common effective date for both market risk and other Basel II disclosures will reduce the compliance burden on U.S. banks, and reduce confusion for market participants.

Fifth, we are concerned that the required increased public disclosures may require the release of proprietary information. Release of such information could have significant competitive impacts. We suggest the Agencies review the required Pillar III disclosures, and ensure that the confidentiality of proprietary information is protected.

With respect to regulatory reporting, we note that the new required filings will create significant compliance burden and systems cost, particularly in the parallel run years. We suggest the Agencies provide greater and more specific guidance on how banks using the advanced approaches will transition to the new reporting requirements, including detail on how the new filing requirements will be integrated into the Call Report system.

Finally, as a general matter, in order to minimize compliance costs, we recommend the Agencies adopt a final rule that provides the greatest possible consistency between Pillar III, bank regulatory reporting, and Securities and Exchange Commission filings.

Comments on Specific Exposures

Portfolio Approach to Rating Exposures

State Street's business model, which relies almost entirely on servicing institutional investors, results in several very high-quality, low-risk portfolios of exposures which we believe do not warrant the granular credit risk analysis generally required under the A-IRB. For example, we provide various credit products to mutual funds regulated by the Securities and Exchange Commission. These portfolios are very low-risk, consistent through economic cycles, and involve a class of counterparties that is highly regulated and homogenous. Analyzing these counterparties on a case-by-case, annual basis, and assigning individual risk ratings to each, as required by the NPR, provides little or no incremental risk management benefit, and creates a substantial compliance burden for the bank.

As an alternative, we suggest the Agencies establish criteria for identifying the types of low-risk, homogenous exposures described above, and permit the treatment of such exposures on a portfolio basis.

Securities Lending --- General Comments

State Street is an active participant in the global securities lending marketplace. Appropriate risk-based capital rules for these transactions are critical to both effective risk management and maintaining the competitiveness of U.S. banks.

Overall, State Street supports the NPR's treatment of securities lending transactions. We believe, in many areas, that the NPR appropriately implements the provisions of the New Accord, and will result in a more risk-sensitive regulatory capital system for securities lending transactions.

There are, however, several areas where we believe the treatment described in the NPR for securities lending transactions can be improved. Our concerns are very similar to those raised by the comments filed on the NPR by the Risk Management Association's Committee on Securities Lending ("RMASL"). State Street participated in the development of RMASL's comments, and strongly agrees with the issues raised in the group's comment letter. We summarize these comments below, and refer the Agencies to the RMASL's comment letter for further detail.

Securities Lending --- Definition of Repo-Style Transaction

We support the NPR's proposed methodology for recognition of the risk mitigating effects of financial collateral that secure repo-style transactions, but have serious concerns with the proposed definition of such transactions.

Under the NPR, repo-style transactions must meet a series of criteria, including Criterion (iii), which requires that the "transaction be executed under an agreement that provides the bank the right to accelerate, terminate, and close-out the transaction on a net basis and to liquidate or set off collateral promptly upon an event of default (including upon an event of bankruptcy, insolvency, or similar proceeding) of the counterparty, provided that, in any such case, any exercise of rights under the agreement will not be stayed or avoided under applicable law in the relevant jurisdictions." The NPR footnotes this criterion, indicating the requirement is met if executed under U.S. law, and is appropriately classified under various provisions of the Bankruptcy Code, the Federal Deposit Insurance Act, the Federal Deposit Insurance Corporations Improvement Act of 1991, or the Federal Reserve Board's Regulation EE.

While we support the goal of Criterion (iii) --- to ensure that recognition of the risk mitigating effect of financial collateral is only provided in cases where the collateral will clearly be available in the case of default --- we are concerned that the provision is too rigid, and will eliminate numerous types of low-risk securities lending and borrowing transactions from the definition of repo-style transaction. Where counterparties are subject to the U.S. laws and regulations referenced in the footnote to Criterion (iii), the provision is appropriate. There are, however, numerous types of typical securities lending and borrowing transactions that could not meet Criterion (iii), including certain transactions under non-US law, transactions with sovereign entities, and transactions with insurance companies and pension funds. While very similar in risk profile to transactions which could meet Criterion (iii), the NPR would fail to recognize the risk mitigation provided by financial collateral in these cases.

We appreciate the Agencies' acknowledgment of the challenges created by Criterion (iii), as indicated in Question 35. We suggest the Agencies adopt the approach suggested by the RMASL for both securities lending and borrowing transactions, which is based on a Final Rule related to securities borrowing transactions issued in February

2006. Under this approach, Criterion (iii) would be retained, and transactions meeting the four criteria proposed in the NPR would qualify as repo-style transactions. Transactions which did not meet the definition due to Criterion (iii), however, could still qualify as repo-style transactions, provided the transactions are either overnight or immediately cancelable at any time by the bank. We believe this approach will more closely align regulatory capital with the risk of all securities lending and borrowing transactions, and, by more closely aligning the U.S. implementation with global implementation, provide U.S. institutions a more level-playing field to compete with their foreign competitors.

Securities Lending --- Collateral and Risk Mitigation

As noted above, we generally support the NPR's methodology for recognizing the risk mitigation provided by financial collateral. Given the low risk of loss, the maintenance of a positive margin of collateral, and the daily marking to market for securities lending transactions, however, we believe the Agencies' proposed definition of financial collateral and the related risk mitigation recognition could be improved.

First, we believe the requirement for a "perfected, first priority security interest or the legal equivalent thereof" may be overly rigid, and not recognize certain common market practices which make such a requirement infeasible. For example, it is common in third-party securities lending transactions for the custodian to be granted a security interest in the assets held in order to secure payment of custodial fees or other amounts. To accommodate such cases in a manner which still recognizes the risk mitigation benefits of the collateral, we suggest the Agencies provide a definition of financial collateral under which the requirement for a perfected, first priority interest can be satisfied if the bank's interest is subject only to a lien of the third party custodian.

Second, we recommend the Agencies modify the definition of financial collateral to make clear that cash must be immediately available to the bank upon default, and to apply the requirement for a perfected, first priority security interest only to collateral other than cash.

Finally, we suggest the Agencies modify the proposal to recognize the risk mitigation benefits of debt securities rated lower than one category below investment grade and other securities (such as credit derivatives) that do not meet the definition of financial collateral. While we understand the convenience of using debt security ratings as a standard for defining financial collateral, the external rating of a debt security is generally less relevant to the risk mitigation benefits of collateral than the liquidity of the security. We recommend the Agencies recognize the risk mitigation value of such securities, provided the markets for the securities are sufficiently liquid.

Securities Lending --- OTC Derivative and Netting Arrangements

Under the NPR, the Agencies propose to retain the current standard for netting agreements covering OTC derivative contracts, which requires a written legal opinion representing that the netting agreement is legally enforceable. However, in Question 38, the Agencies seek comment on "methods banks would use to ensure enforceability

of single product OTC derivative netting agreements in the absences of an explicit written legal opinion requirement."

We agree that written legal opinions may sometimes remain appropriate, but believe there are several opportunities for the Agencies to reduce the need for such opinions.

First, FDICIA provides considerable confirmation of the enforceability of netting contracts among "financial institutions." We suggest that a representation from each party to an OTC derivative netting agreement related to a securities lending transaction that such party is a financial institution, as defined in FDICIA (12 U.S.C. § 4402(9)), should be sufficient demonstration, without additional opinion of counsel, of the legal enforceability of the netting agreement.

Second, we believe the use of industry developed standardized contracts, and reliance on commissioned legal opinions as to the enforceability of these contracts in many jurisdictions, should be sufficient to determine enforceability.

Securitizations – General Comments

In general, State Street supports the approach to securitizations proposed by the NPR. We are strongly supportive of the inclusion of the Internal Assessment Approach for ABCP programs. In addition, we appreciate the numerous changes the Agencies have made to the NPR in response to comments and suggestions raised in relation to the August 2003 ANPR.

Like other U.S. banks, however, we believe the proposal described in the NPR could be improved through several specific changes. We have participated in the development of the comments of the American Securitization Forum, and support the recommendations of the ASF, but particularly emphasize the following suggestions, which are of particular importance to State Street.

Securitizations --- Definition of Originator

State Street supports the generally neutral treatment under the New Accord for banks holding securitization exposures, regardless of whether the bank is considered an originator of the underlying assets or an investor in the securitization. The NPR, however, diverges from the New Accord, and, under the Ratings Based Approach ("RBA"), requires two external ratings for originators, as compared to one external rating for investors.

We urge the Agencies to align the final U.S. rules with the New Accord, and require only one external rating for both originators and investors for the RBA. Under existing ratings agency practices, adding a requirement for a second external rating does little to enhance the reliability of the RBA process, and such an unnecessary divergence from the New Accord creates additional complexity and compliance burden for US banks with little or no increase in risk sensitivity.

As noted, we would prefer that the Agencies remove the proposed distinction between originators and investors under the RBA. Should the Agencies decide to retain this distinction, however, we request that the Agencies reconsider their definition of "originator," and treat sponsors of Asset Backed Commercial Paper ("ABCP") conduits as investors, rather than originators. Treating sponsors of ABCP conduits as investors, rather than originators, more closely reflects the nature of the relationship between a sponsor and the conduit. In State Street's case, for example, the vast majority of the assets that are in the conduits are rated public or 144A securities.

Securitizations --- Flexibility to Accommodate Niche Portfolios

The NPR requires a deduction for capital for any securitization exposures for which a bank cannot calculate regulatory capital under any of the three available approaches. While such a treatment may, in many cases, be appropriate, situations can exist where a niche portfolio cannot meet the technical requirements of the RBA, Internal Assessment Approach ("IAA"), or the Supervisory Formula Approach ("SFA"), but where a deduction from capital of the entire exposure is clearly overly punitive. In State Street's case, for example, there are unrated exposures that are not funded in the conduits, but the underlying assets are student loans guaranteed by the Department of Education. State Street does not originate the loans, and therefore does not have access to the detailed information required to use the SFA. Consequently, none of the three approaches would be available. Given the low risk posed by these exposures, requiring a deduction for capital is overly punitive, and non-risk sensitive. In such cases, we suggest that the Agencies provide for sufficient supervisory flexibility to ensure that reasonable and logical approaches are not precluded due to overly prescriptive rules.

Securitizations --- Approval Process for the IAA Approach

An effective approval process for the IAA approach is essential for U.S. banks, and we urge the Agencies to ensure that the IAA become available in a timely fashion, with a clear, efficient, and transparent approval process. We strongly agree with the American Securitization Forum's suggestion to quickly adopt a "submission and non-objection" approach. Under this approach, regulators are provided sufficient information to review and, if necessary, object to a bank's internal assessments, and banks are provided the ability to move forward expeditiously with the proposed approach, minimizing disruption and competitive differences.

Securitizations --- ABCP Qualification Criteria

As a general matter, we urge the Agencies to adopt a more flexible approach to the ABCP qualification criteria described in section 44(a)(2). As proposed in the NPR, it appears that the Agencies contemplate an "all-or-nothing" approach, where the existence of any exposures in an ABCP program that do not meet the qualification criteria will disqualify the entire program from IAA treatment. As an alternative, we suggest the Agencies allow use of the IAA for any qualifying exposures within a particular ABCP program, regardless of the need to use other approaches for IAA-ineligible exposures.

In addition, we suggest the Agencies adopt a more flexible approach to several of the proposed ABCP qualification criteria. Specifically, we view the criteria described in section 44(a)(2)(iv), related to past due or defaulted assets, and 44(a)(2)(vi), related to mitigation for potential credit deterioration, as overly restrictive. While both of these factors may be important in certain circumstances, establishing these as absolute IAA qualification requirements is overly prescriptive, and fails to recognize alternative approaches which can address the concerns behind the Agencies' proposal in a manner more reflective of competitive and market forces. We suggest that these issues be eliminated from the IAA qualification criteria, and addressed through NRSO criteria or consultation instead.

Securitizations --- Flexibility Related to Rating Agency Criteria

We agree that for many asset classes and structures, the IAA should be based on "publicly available rating criteria used by an NRSRO." In some cases, particularly for new or innovative products, such rating criteria has not yet been issued to the public. For example, in many cases, a rating agency will not publicly issue available methodology details until numerous transactions for that particular asset have been completed. In these cases, the existing practice is to consult with the applicable rating agency to supplement or substitute for the agency's published criteria. We request the Agencies adopt a sufficiently flexible final rule to allow such practices to continue, as has been done by the U.K. FSA.

Securitizations --- Look-Through Approach

In cases where a liquidity commitment is an obligation to step into a funded position, we believe the exposure should have the same risk weight as the underlying asset. In such instances, it is reasonable to assume that the liquidity commitment would not subject the bank to greater risk than if the bank had already funded the position.

We recommend the final rule provide a look-through approach for transaction-specific liquidity facilities where (a) the underlying asset has an external rating, and (b) upon a draw under the liquidity facility, the liquidity bank obtains a contractual claim on the collection from the underlying asset.

Securitizations --- Seniority

Question 47 of the NPR requests comment on the "appropriateness of basing the risk-based capital requirement for a securitization exposure under the RBA on the seniority level of the exposure."

We do not disagree with the concept adopted by the NPR in this area, but suggest the Agencies avoid adopting an overly narrow definition of seniority for this purpose.

In many transactions a large class of exposures that is rated in the highest investment grade category (typically Class A) is subdivided into a series of sequential pay time

tranches. Investors in the tranches receive payments of principal sequentially. Such structures enable originators to target investor demand for particular maturities.

We request the Agencies clarify that, for cases where multiple, sequential pay time tranches all have the same external rating, the time tranching will not affect seniority. In these cases, there may be more than one tranche that is designated as senior.

In addition, we recommend the Agencies align the final rule with the EU's Capital Requirements Directive ("CRD") in relation to super senior exposures. The CRD provides a 6% risk weight for some super senior exposures and, in some cases, permits other exposures as senior, notwithstanding the presence of these super senior exposures. We believe this approach is reasonable, and, for both risk management and competitive reasons, suggest it be adopted in the U.S. final rule.

Contingent Credit Exposure --- General Comments

In general, State Street supports the treatment under the NPR of contingent credit exposures, such as those associated with over-the-counter derivatives and repo-style transactions. For these exposures, credit mitigation techniques, including the use of collateral, netting, and early termination rights, are important elements of risk management, and we believe the NPR generally provides appropriate recognition of these techniques. In addition, State Street supports the availability under the NPR of a range of allowable capital calculation methods for these exposures, varying in complexity and risk-sensitivity, which will allow banks the ability to tailor risk management approaches to their individual business models.

There are, however, several technical aspects of these calculations that may warrant further consideration, which are described below.

Contingent Credit Exposure --- Calculation of *alpha*

State Street suggests the Agencies reconsider the provisions of the NPR establishing a floor for internal calculations of *alpha* for purposes of determining regulatory capital for contingent credit exposures.

Under the NPR, banks using the internal models methodology for measuring contingent credit risk are required to use a scaling factor ("*alpha*") to address the potential for economic downturn conditions. *Alpha* is set at 1.4, but, with supervisory approval, could be estimated individually by banks, subject to a floor of 1.2. State Street is concerned this arbitrary floor may reduce the risk-sensitivity of the NPR, and suggests the Agencies provide greater flexibility in the appropriate level of *alpha*.

The NPR establishes *alpha* as the ratio of economic capital from full simulation that incorporates joint simulation of market and credit risk factors (numerator) to economic capital based on expected positive exposure (denominator). We believe this approach can result in a reasonable and conservative calculated *alpha* of less than 1.2. In brief, the numerator includes a more granular calculation that integrates the joint evolution of potential future changes in exposure with contemporaneous changes in default

likelihood, whereas the denominator reflects a form of average exposure over a defined time period multiplied by the default likelihood over that time period. As such, *alpha* may be larger when counterparties tend to exhibit increasing hazard rates, since joint simulation, as required in the numerator of the *alpha* calculation, would more effectively measure risk when latter period increases in default likelihood occur jointly with larger potential future exposures. Alternatively, *alpha* is likely to be smaller – potentially even less than 1 – when counterparties tend to exhibit decreasing hazard rates, since default likelihoods would tend to grow smaller during time periods when potential exposure increases. Setting a floor of 1.2 for *alpha* could therefore create competitive disadvantages for banks with customers that encompass a broad mix of credit migration characteristics.

Contingent Credit Exposures --- Effective Maturity Parameter

The proposal establishes the effective maturity parameter ("M") to reflect the impact on capital of "changes in economic value that stem from deterioration in the counterparties creditworthiness short of default." We don't disagree that such a parameter can be useful in capturing relevant risk, but note that similar concepts may also be included in valuation and credit reserve calculations. We recommend the Agencies provide sufficient flexibility to avoid potential double-counting of this risk.

Contingent Credit Exposures --- Implied Volatilities

The proposal encourages banks to "incorporate model parameters based on forward-looking measures – for example, using implied volatilities in situations where historic volatilities my not capture changes in the risk drivers anticipated by the market – where appropriate." However, there is not uniform agreement in the financial literature that implied volatilities are effective predictors of future spot volatility, and we are concerned that the proposal in the NPR may be interpreted to require the use of such factors in banks' internal models.

As a result, we suggest the Agencies adopt a final rule that provides banks flexibility in the parameter estimation process and relies on independent model validation processes to confirm the appropriateness of parameter estimation techniques.

Equity Exposures

We have have noted general industry concerns with the proposed treatment of equity exposures, and we generally agree with these concerns. In particular, we believe the proposed 10% of Tier 1 plus Tier 2 risk-based capital threshold for increased capital requirements for equity exposures is more conservative than the current rules, and should be recalibrated. In addition, we agree with the general industry view that the structure of the proposed internal model approach (IMA) for equity exposures makes it unlikely Basel II banks will choose to use the IMA. Finally, we suggest the Agencies reconsider their proposed treatment of investment funds "with material liabilities" and provide greater clarity on the treatment of hedge funds.

Conclusion

Once again, State Street appreciates the Agencies' willingness to consider our views in relation to the U.S. implementation of Basel II. As noted above, we strongly urge the Agencies to provide for a phased-in and flexible approach to qualification for the advanced approaches, and to eliminate the leverage ratio requirement for banks adopting the advanced approaches. By adopting the suggestions detailed above, we believe the Agencies can expeditiously adopt final rules for U.S. implementation that are more consistent with the international agreement reached in the New Accord, and minimize competitive and compliance challenges for U.S. banks.

Sincerely,