

# Test Case on the Charles

State Street and the Volcker Rule

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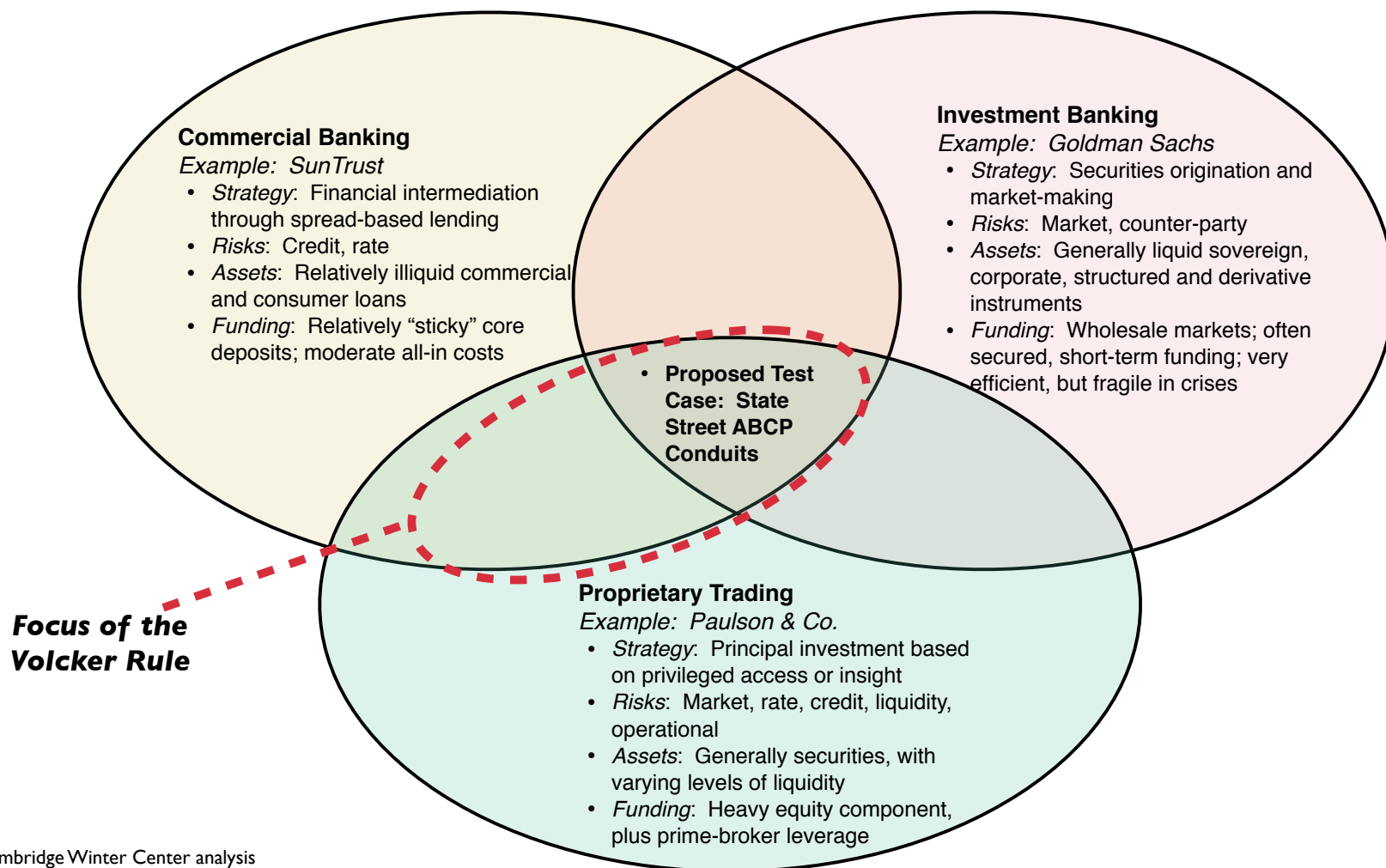
# EXECUTIVE SUMMARY

Policy makers should judge legislative proposals on the “Volcker Rule” in part through a simple test case: would the Rule as formulated have mitigated the significant financial risks posed by State Street’s asset-backed commercial paper conduit businesses during the credit bubble?

- **Conference Committee must address the Volcker Rule.** One of the issues that must be resolved by the Conference Committee on financial reform is the nature and scope of the so-called “Volcker Rule”, which would bar bank holding companies and their affiliates from putatively high-risk activities like private equity investing, managing hedge funds, and proprietary trading. The Senate bill included one version of such prohibitions, while the House bill (which was passed one month before the Administration’s Volcker Rule proposal in January) generally did not.
- **Specific test case would clarify debate.** Proponents of the Volcker Rule, and its variants, have struggled to articulate the precise bubble-era problems that the Rule would have prevented. This is unfortunate, because it has tended to undermine the perceived exigency of the issue, and it makes it difficult to evaluate whether any proposed provision is sufficiently strong, or whether any proposed exemption from the Rule is too broad.
- **State Street is the ideal test case.** State Street, the Boston-based custody bank, is the best litmus test for whether the Volcker Rule has been properly crafted. A Rule crafted too narrowly to cover State Street, or an exemption crafted so widely as to exclude State Street, would be ill-advised.
  - **State Street matters.** Despite its relatively modest size (it is the 19th largest bank holding company), State Street is systemically important given its \$19 trillion custody business, which serves as a core part of the “plumbing” of the global capital markets. Notably, custody is a relatively low-risk (albeit market sensitive) business line, and one that, by all accounts, State Street manages extraordinarily well.
  - **State Street embraced higher-risk, off-balance sheet investment management businesses.** During the credit bubble, State Street grew a number of higher-risk investment management businesses more typically associated with investment banks or hedge funds -- e.g. the management of cash collateral pools related to securities lending; or the management of off-balance sheet conduits that invested heavily in U.S. consumer asset-backed securities.
  - **Higher-risk businesses pressured capital and liquidity, but taxpayers came to the rescue.** As the credit cycle turned, State Street’s non-core investment management businesses -- particularly the conduit business -- pressured the bank’s funding and capital base. The bank ultimately elected to directly support its off-balance sheet vehicles with its own balance sheet. The resultant pressures on both liquidity and capital were mitigated by State Street’s liberal use of taxpayer-supplied rescue vehicles -- including the TARP, TLGP, and CPFF.

Debate over the Senate bill's Volcker Rule has been muddled by the absence of a clear test case from the credit crisis: that is, an otherwise well-managed commercial bank (not a broker dealer or universal bank) that required taxpayer support in part because of its sponsorship of higher-risk investment management vehicles. There are, in fact, very few obvious examples of this problem in the most recent crisis, but State Street's off-balance sheet asset-backed commercial paper conduits fit the bill.

## VOLCKER RULE TEST CASE: STATE STREET ABCP CONDUITS



Source: Cambridge Winter Center analysis

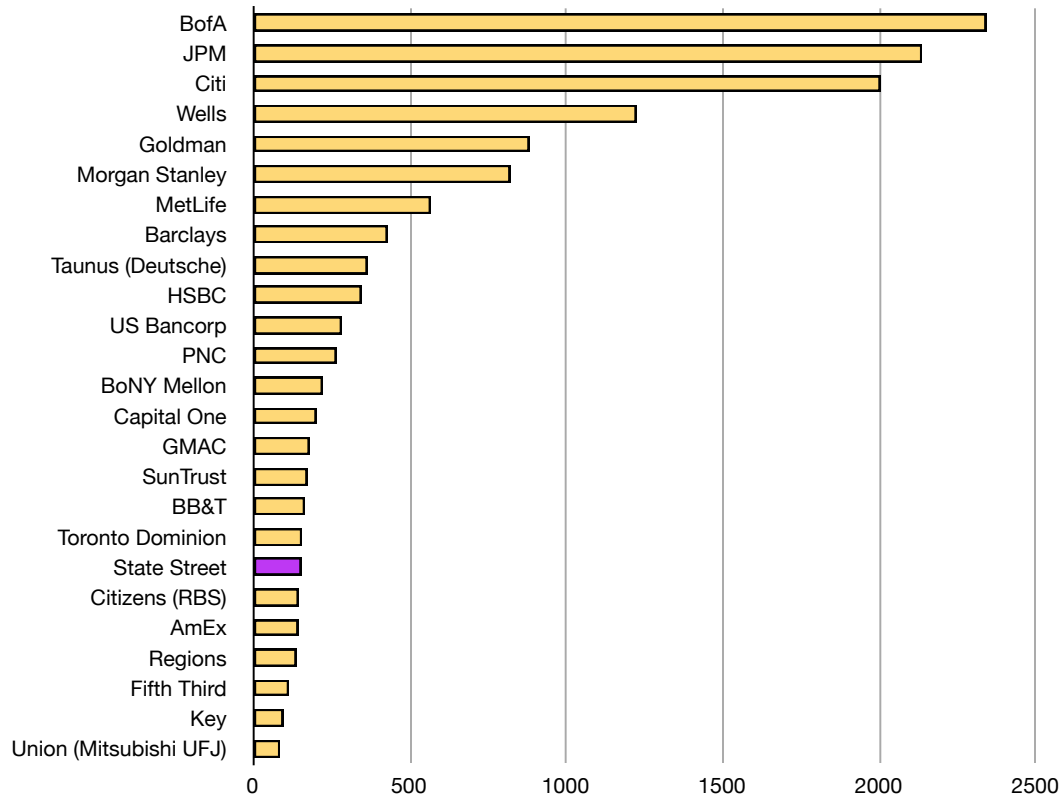
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At first glance, State Street would seem an unlikely test case for the Volcker Rule. It is, after all, only the 19th largest bank holding company, with roughly \$150 billion in assets. But like Bank of New York Mellon, and to a lesser extent Northern Trust, State Street has a systemic importance that is vastly disproportionate to its balance sheet size. State Street serves as “custodian” for more than \$19 trillion in assets.

## STATE STREET SIZE AND IMPORTANCE

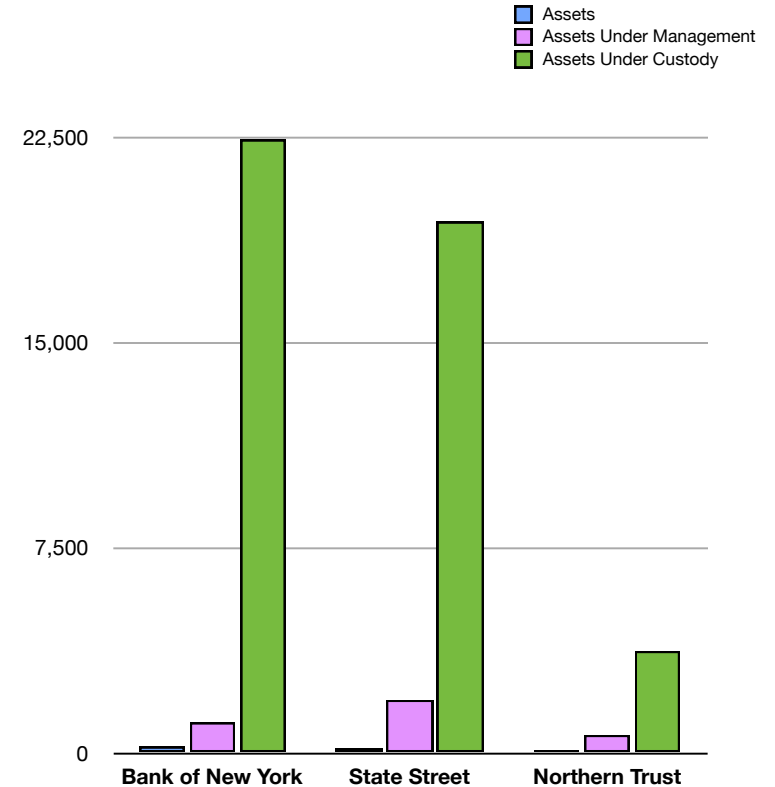
### Assets of Top 25 Bank Holding Companies, IQ10

\$ Billions



### Large U.S. Custody Banks' Assets, AUM, and AUC, IQ10

\$ Billions



Source: FFIEC; SNL; Cambridge Winter Center analysis

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The “custody” business -- which State Street generally calls “investment servicing” -- is the larger of two business lines at the bank. To most observers, custody is a dreadfully dull affair: a scale-intensive, IT-dependent processing business in which low-cost operations are key and pricing is measured in single-digit basis points. Although its revenues are market-sensitive, it is typically viewed as a lower-risk banking business, given that it is not prone to large credit- or interest rate-risk shocks.

## INVESTMENT SERVICING AT STATE STREET

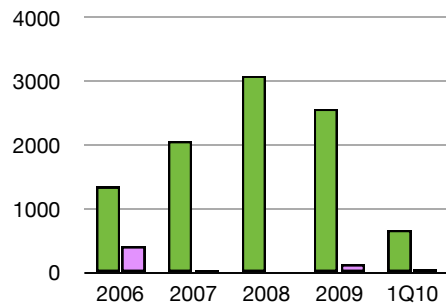
### Revenue by LOB, 2006-1Q10

\$ Millions



### Pretax Income by LOB, 2006-1Q10

\$ Millions



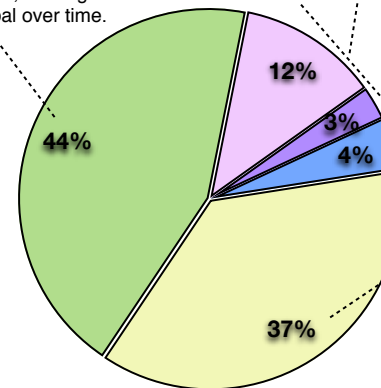
### Investment Servicing Revenue Breakdown, 1Q10

100% = \$2.012 billion

- Servicing fees
- Trading services
- Securities finance
- Processing fees & other
- Net interest income & gains

**Custody fees.** “Custody” refers to the physical and electronic safekeeping and record-keeping of equity, fixed income, and money market securities for institutional investors. With \$19 trillion in assets under custody, State Street is a massive player in this scale-intensive business, and its clients include an impressive roster of insurers, mutual funds, pension funds, and hedge funds. State Street remains more than 60% US-focused in its customer base, although it has become more global over time.

**Ancillary fees.** Over time, custody banks’ profitability has come to rely on several ancillary businesses, which are natural add-ons to the core custody offering. The most significant: foreign exchange trading revenues from clients’ cross-border trading flows; securities finance, in which clients’ securities are loaned to investors who want to sell them short; and a variety of fee-based performance analytics businesses.



**Net interest income & gains.** This is conceptually similar to the core function at most commercial banks. Customer deposits and other funding is invested in a securities portfolio, and the difference in spreads results in net interest income. Different than most banks, State Street’s funding base relies on its institutional investor clients, not retail or small business customers. Similarly, its assets are principally investment grade securities, not loans.

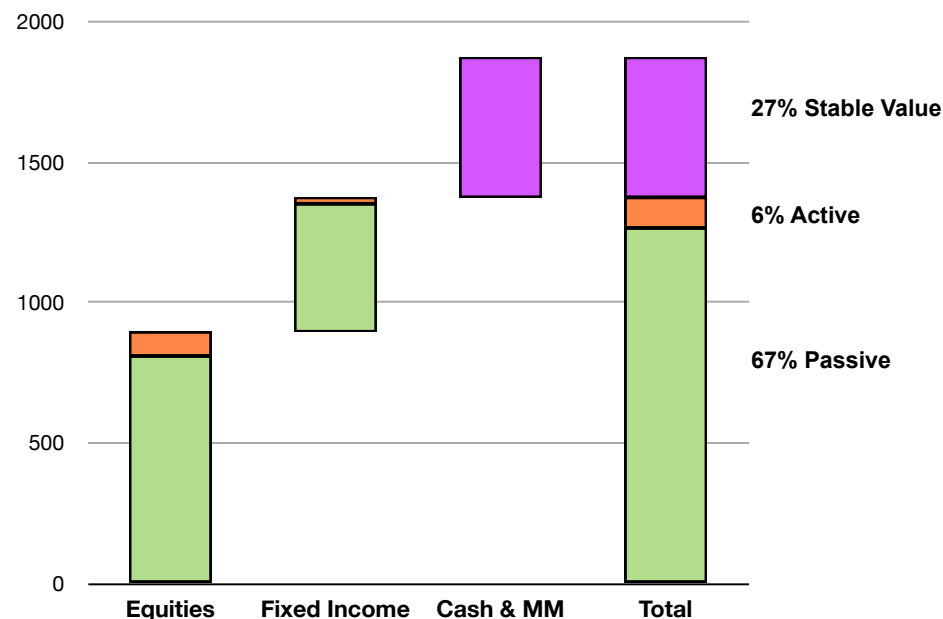
Source: State Street Forms 10Q, 10K; Cambridge Winter Center analysis

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The \$1.9 trillion “investment management” business at State Street has also been, for the most part, a relatively low-risk activity. The bank is a global leader in “passive” investment management, which most individual investors know as “index” investing. During the credit bubble, though, State Street grew more risky asset management businesses, like the management of the cash collateral pools associated with securities lending, and the sponsorship of large off-balance sheet asset-backed commercial paper conduits. It is those businesses, particularly the conduit business, that are relevant to an evaluation of the Volcker Rule.

## INVESTMENT MANAGEMENT AT STATE STREET

**State Street Assets Under Management, 1Q10**  
\$ Billions



### Major Trouble Spots

- Securities lending cash collateral pools.** When customers’ securities are loaned away, State Street receives cash collateral in return. That collateral is meant to be invested in low-risk pools managed by State Street, and redemptions from those pools are structured to be at par value. Fair value dropped considerably below par during the crisis and, as of 1Q10, still have not recovered. Nonetheless, State Street has allowed some customers to redeem at par.
- Wrapped stable value funds.** State Street sold stable-value funds that were “wrapped” by third party insurers. As the market value of those funds plummeted during the crisis, wrap providers threatened to exercise their rights to terminate their coverage. To avoid that, State Street used its own balance sheet to buy \$2.49 billion of troubled assets from the funds, at a \$450 million loss to the bank.
- Asset-backed commercial paper conduits.** As early as 1992, State Street began sponsoring off-balance sheet vehicles that would fund themselves through commercial paper (that is, short term IOU’s) sold to customers, and would purchase asset-backed and mortgage-backed securities. These off-balance sheet portfolios had grown to almost \$29 billion by the end of the credit bubble -- and were subsequently bailed out by the bank’s balance sheet.

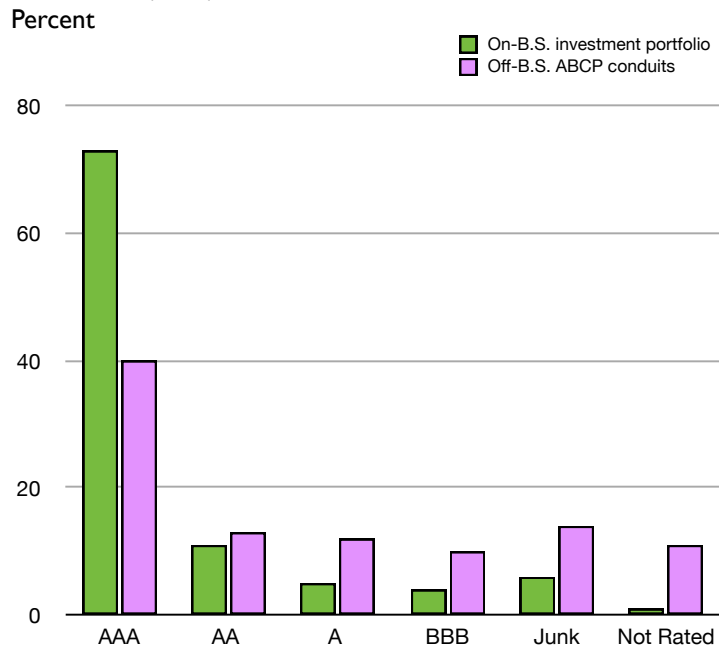
Source: State Street SEC filings, earnings calls

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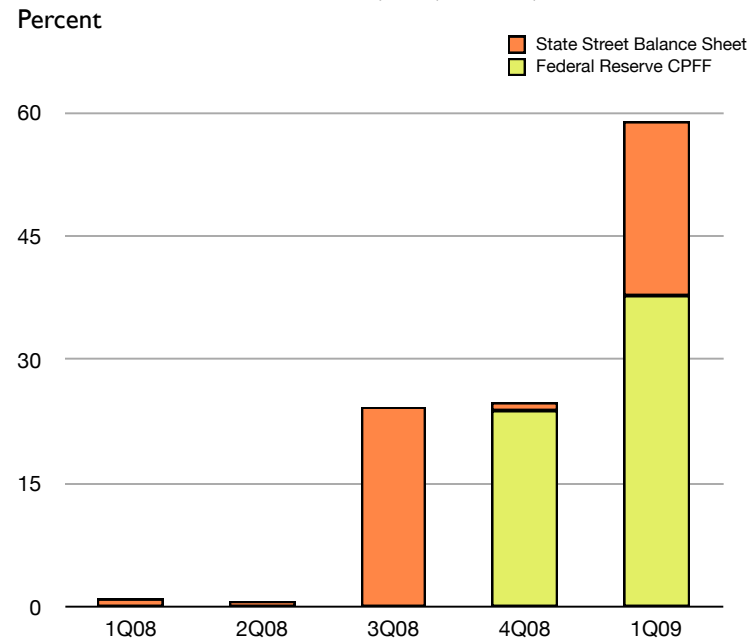
State Street's off-balance sheet conduits were intentionally designed to take more credit risk than the generally conservative bank permitted on its own balance sheet. The conduits also operated with greater liquidity risk, as they funded medium- and long-term asset-backed securities through, in large measure, short-term commercial paper. Not surprisingly, the credit crisis triggered significant deterioration in the conduit's higher-risk assets, which in turn exacerbated the difficulty in refinancing the conduits' short-term commercial paper funding as it matured. By 1Q09, State Street was using a combination of its own deposit-funded balance sheet and the Fed's emergency CPFF to provide 59% of the conduits' funding.

## STATE STREET'S BAILOUT OF ITS CONDUITS

### ABCP Conduits vs. Investment Portfolio, 1Q09



### State Street and Fed Funding of "Off Balance Sheet" ABCP Conduits, 1Q08-1Q09



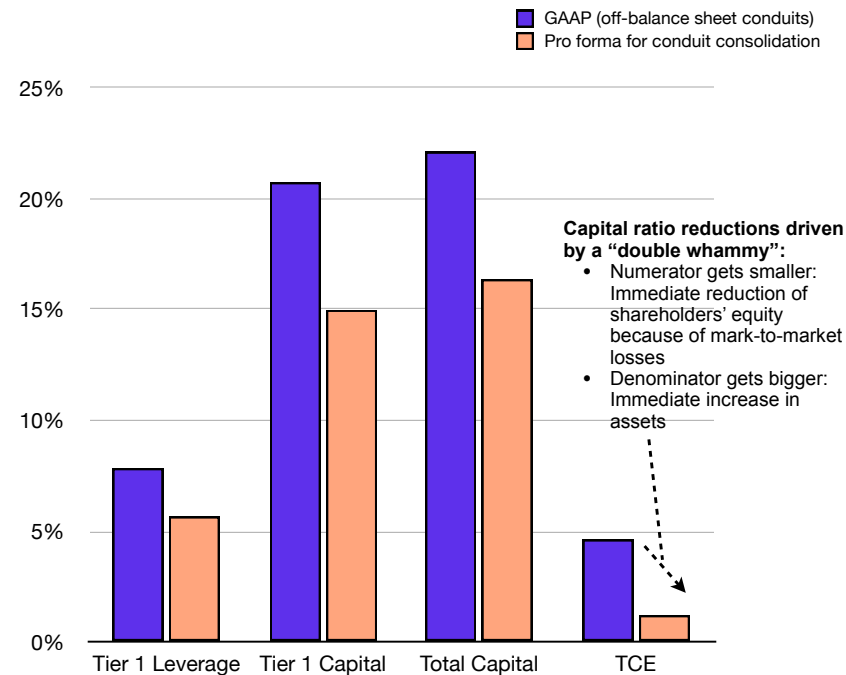
Source: State Street 8K filings ("Asset Backed Commercial Paper Presentation" and "Investment Portfolio Presentation", April 21, 2009); Cambridge Winter Center analysis

The prospect of consolidating its off-balance sheet investment management vehicles, of course, put potential pressure on State Street's capital ratios. Indeed, despite announcing otherwise solid 2008 results, State Street's stock dropped nearly 60% in a single day in January 2009 as it disclosed the potential impact of conduit consolidation, and that it had chosen not to raise capital in the private markets.

## CONDUITS THREATENED STATE STREET CAPITAL RATIOS

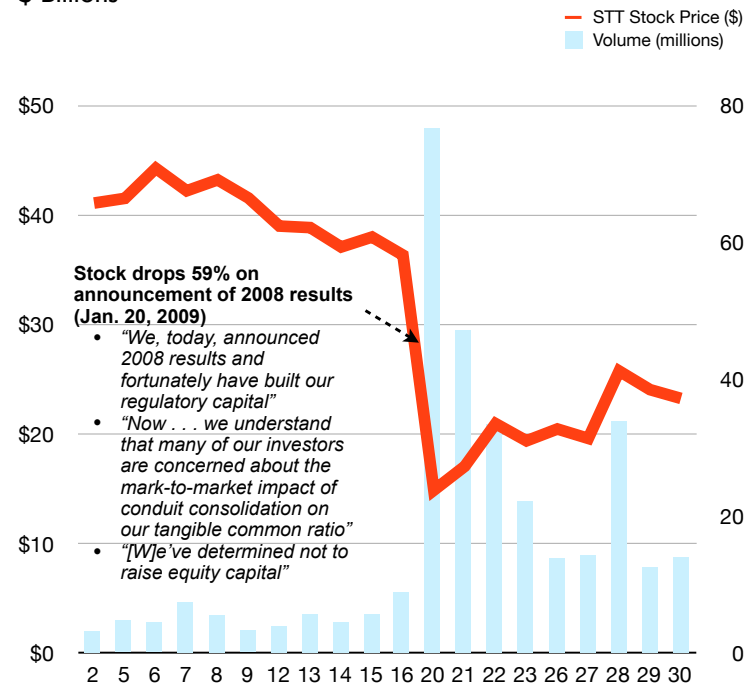
### ABCP Conduits Consolidation Pro Forma Impact on Capital Ratios, 4Q08

Percent



### State Street Stock Price Performance, January 2009

\$ Billions



Source: CallStreet transcript; SNL; State Street 8K filing ("Asset-Backed Commercial Paper, As of December 31, 2008"); Cambridge Winter Center analysis

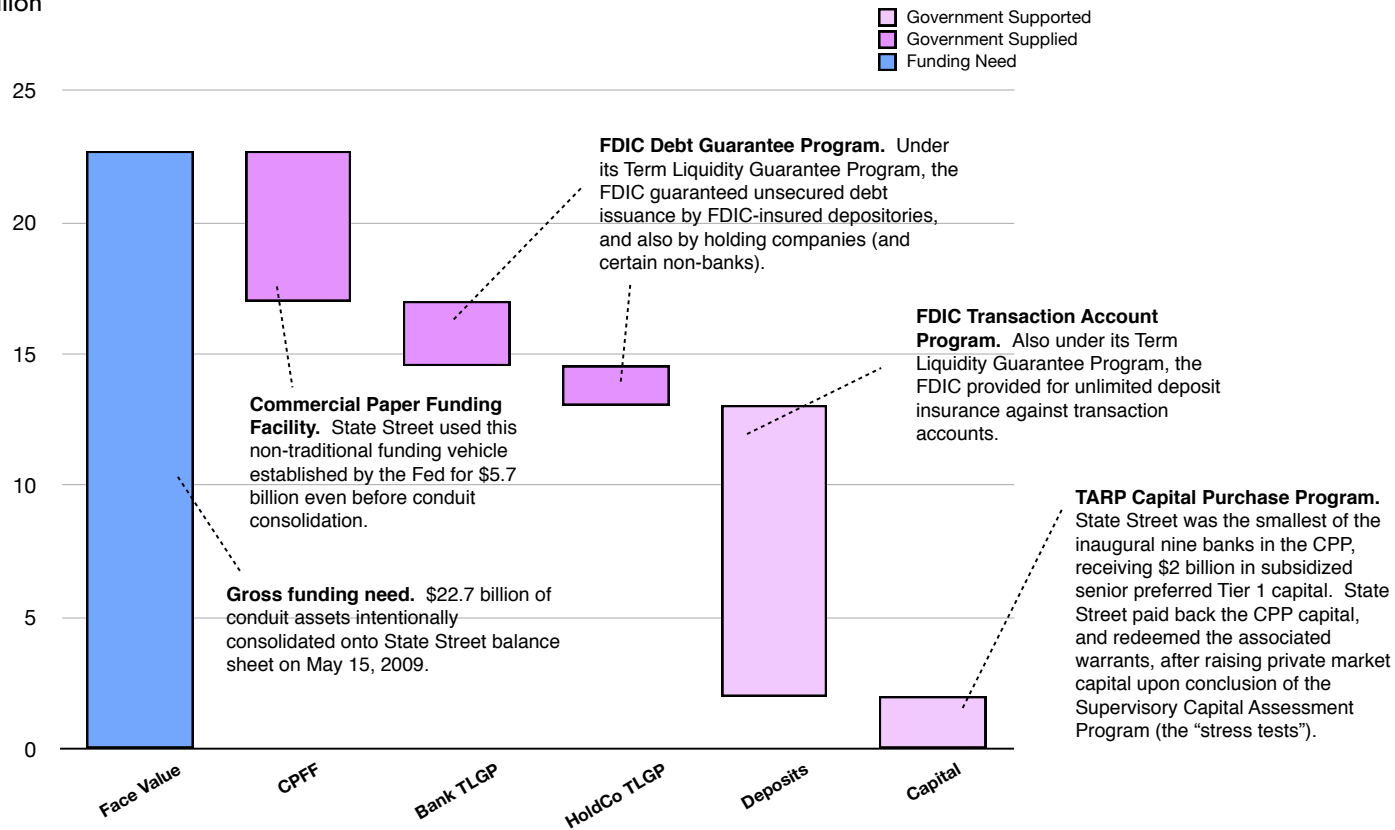
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Sure enough, State Street did, in May 2009, bring on balance sheet its previously off-balance sheet ABCP conduits. State Street did not face a liquidity run, however, in major part because of pre-existing funding backstops provided by the Fed's Commercial Paper Funding Facility ("CPFF") and the FDIC's Term Liquidity Guarantee Program ("TLGP"), coupled with taxpayer-supplied capital through the TARP and a post-"stress test" private market equity raise.

## STATE STREET'S TAXPAYER ASSISTANCE

### Taxpayer Support versus Conduit Impact

\$ Billion



Source: SIGTARP; State Street SEC filings; FDIC; Cambridge Winter Center analysis

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