November 19, 2019

MEMORANDUM TO: Board of Directors

FROM: Doreen R. Eberley, Director

SUBJECT: Regulatory Capital Rule: Revisions to the Supplementary Leverage Ratio to Exclude Certain Central Bank Deposits of Banking Organizations Predominantly Engaged in Custody, Safekeeping and Asset Servicing Activities

Summary: Staff are presenting for approval of the Federal Deposit Insurance Corporation (FDIC) Board of Directors (FDIC Board) a request to publish the attached interagency final rule (final rule) to amend the regulatory capital rule of the FDIC, the Office of the Comptroller of the Currency (OCC), and the Board of Governors of the Federal Reserve System (FRB) (collectively, the agencies) to exclude from the supplementary leverage ratio certain central bank deposits of custodial banks, in accordance with section 402 of the Economic Growth, Regulatory Relief, and Consumer Protection Act (EGRRCPA)(section 402). Section 402 defines a custodial bank as any depository institution holding company predominantly engaged in custody, safekeeping, and asset servicing activities, including any insured depository institution (IDI) subsidiary of such a holding company.

Recommendation: FDIC staff are requesting the FDIC Board approve the interagency final rule and authorize its publication in the *Federal Register* with an effective date of April 1, 2020.

Discussion:

Concur:

Nicholas J. Podsiadly
General Counsel

I. Background

A. *Custody Banks and the Current Leverage Capital Requirements*

Certain banking organizations offer fiduciary, custody, safekeeping, and asset servicing services. Fiduciary and custody clients often maintain cash deposits at the banking organization in connection with these services. These cash deposits fluctuate depending on the activities of the clients. For example, deposit balances generally increase during periods when customers sell securities. To manage these fluctuations, banking organizations may maintain cash deposits at central banks. Under U.S. generally accepted accounting principles, central bank deposits are on-balance sheet assets for such organizations.

The supplementary leverage ratio measures tier 1 capital relative to total leverage exposure, which includes on-balance sheet assets (including deposits at central banks) and certain off-balance sheet exposures.[1] A minimum supplementary leverage ratio of 3 percent applies to certain banking organizations and their insured depository institution subsidiaries.[2] In addition, banking organizations subject to Category I standards, which are the global systemically important bank holding companies (U.S. GSIBs), as well as their insured depository institution subsidiaries, are subject to enhanced supplementary leverage ratio (eSLR) standards. The eSLR standards require each U.S. GSIB to maintain a supplementary leverage ratio above 5

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[1] 12 CFR 3.10(a)(5)), 3.10(c)(4) (OCC); 12 CFR 217.10(a)(5)), 217.10(c)(4) (Board); 12 CFR 324.10(a)(5)), 324.10(c)(4) (FDIC).

[2] The agencies recently adopted final rules tailoring the application of capital requirements, including the supplementary leverage ratio, based on a banking organization's risk profile (tailoring rules). *See* [FR publication], available at https://www.federalreserve.gov/aboutthefed/boardmeetings/20191010open.htm. Under the tailoring rules, the minimum supplementary leverage ratio requirement apply to banking organizations subject to Category I, II, and III standards. The tailoring rules will be effective [60 days after publication in the Federal Register]. Until the tailoring rules are effective, the supplementary leverage ratio applies to advanced approaches banking organizations.

percent to avoid limitations on the firm's distributions and certain discretionary bonus payments and also require each of its insured depository institutions to maintain a supplementary leverage ratio of at least 6 percent to be deemed "well capitalized" under the prompt corrective action framework of each agency.[3]

B. *Section 402 of EGRRCPA*

Section 402 requires the agencies to amend the supplementary leverage ratio to not take into account funds of a custodial bank that are deposited with certain central banks. Amounts that exceed the total value of deposits of the custodial bank linked to fiduciary or custodial and safekeeping accounts, however, shall be included when calculating the supplementary leverage ratio.[4] Under section 402, central bank deposits that qualify for the exclusion include deposits of custodial banks placed with (1) the Federal Reserve System, (2) the European Central Bank, and (3) central banks of member countries of the Organisation for Economic Co-operation and Development (OECD) meeting certain criteria.[5] As noted above, section 402 defines a custodial bank as "any depository institution holding company predominantly engaged in custody, safekeeping, and asset servicing activities, including any insured depository institution subsidiary of such a holding company."[6]

C. *Proposal to Implement Section 402*

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[3] *See* 79 FR 24528 (May 1, 2014). Under OCC and FDIC rules, a depository institution that is a subsidiary of a bank holding company with more than $700 billion in total consolidated assets or more than $10 trillion in assets under custody is subject to the eSLR standards. 12 CFR 6.4(c) (OCC); 12 CFR 324.403(b) (FDIC). Under the Board's rule, a bank holding company that is a U.S. GSIB is subject to the eSLR standards. *See* 12 CFR 217.11(d); 12 CFR part 217, subpart H.

[4] P.L. 115-174, § 402(b)(2)(B).

[5] The OECD is an intergovernmental organization founded in 1961 to stimulate economic progress and global trade. A list of OECD member countries is available on the OECD's website, www.oecd.org. See P.L. 115-174, § 402(b)(1)(C).

[6] § 402(a).

In April 2019, the agencies published a notice of proposed rulemaking (the proposal)[7] to implement section 402. The proposal would have implemented section 402 by defining the scope of banking organizations considered to be predominantly engaged in custody, safekeeping, and asset servicing activities, and by providing the standard by which such banking organizations would determine the amount of central bank deposits that could be excluded from total leverage exposure. Under the proposal, a depository institution holding company with a ratio of assets under custody (AUC)-to-total assets of at least 30:1 would have been considered predominantly engaged in custody, safekeeping, and asset servicing activities. Such a banking organization would have been termed a "custodial banking organization" under the proposal. A custodial banking organization would have been able to exclude deposits placed at a "qualifying central bank," which would have included the Federal Reserve Bank, the European Central Bank, and the central banks of member countries of the OECD meeting certain criteria. The amount of central bank deposits that could have been excluded from total leverage exposure would have been limited by the amount of deposit liabilities of the custodial banking organization that are linked to fiduciary or custody and safekeeping accounts.

D. *Comments Received on the Proposal*

The agencies collectively received six comment letters from banking organizations and other interested parties. Some commenters were supportive of the agencies' proposal to implement section 402. Other commenters provided suggestions regarding technical aspects to the proposal. Other commenters acknowledged that the agencies are required to implement section 402 but raised various concerns regarding the potential effect that implementation of section 402 would have on other aspects of the banking sector. For example, two of these

[7] 84 FR 18175 (April 30, 2019).

commenters raised concerns that implementation of section 402 would provide custodial banking organizations with a competitive advantage relative to banking organizations that are subject to the supplementary leverage ratio but would not be eligible to exclude central bank deposits. Another commenter noted that, while the agencies are required to implement section 402, the agencies are not prevented from using other authorities to counteract the potential effects of section 402 through making changes to other parts of the capital rule.

Staff has considered all the comments received on the proposal. As described in more detail below, the final rule would adopt the proposal as final. The agencies are required under section 402 to amend the capital rule to exclude from the supplementary leverage ratio certain central bank deposits of banking organizations predominantly engaged in custody, safekeeping, and asset servicing activities. Staff believes that the agencies adoption of the proposal would fulfill this statutory requirement. The final rule would become effective April 1, 2020.

II. Final Rule to Implement Section 402

A. Scope of Applicability

Staff interpret the phrase "predominantly engaged in custodial, safekeeping, and asset servicing activities" in section 402 to mean that the banking organization's business model is primarily focused on custody, safekeeping, and asset servicing activities, as compared to its other commercial lending, investment banking, or other banking activities.[8] Under the final rule, a depository institution holding company is considered "predominantly engaged in custody,

[8] See, e.g., 115 Cong. Rec. S1544 (Mar. 8, 2018) (statement of Sen. Corker) ("Section 402 is not intended to provide relief to an organization engaged in consumer banking, investment banking, or other businesses, and that also happens to have some custodial business or a banking subsidiary that engages in custodial activities . . . section 402 was intended as a very narrowly tailored provision, focused on true custodial banks"); see also H.R. Rep. No. 115-656, at 3-4 (2018) ("Banks that have a predominant amount of businesses derived from custodial services are different from banks that engage in a wide variety of banking activities").

safekeeping, and asset servicing activities" if the U.S. top-tier depository institution holding company in the organization has a ratio of AUC-to-total assets of at least 30:1. AUC equals the average of a U.S. top-tier depository institution holding company's assets under custody for the four most recent calendar quarters, and total assets equals the average of the U.S. top-tier depository institution holding company's total consolidated assets for the four most recent calendar quarters.

In conjunction with the proposal, staff considered other measures that could be used to identify and define a custodial banking organization, including an income-based measure and an absolute amount measure. Staff's analysis indicated that both the AUC-to-total assets measure and the income-based measure identified the same banking organizations that are predominantly engaged in custody, safekeeping, and asset servicing activities.[9] Staff supports the AUC-to-total assets measure to define a custodial banking organization because it is a measure of the size of a banking organization's custodial, safekeeping, and asset servicing business as compared with its other activities, is objective and publically reported, and is subject to review by regulators, banking organizations, and the public. In addition, because AUC is often comprised of marketable securities or other assets with widely-quoted market values, banking organizations typically exercise little or no valuation discretion when measuring AUC. A banking organization's total assets reflect the size and scope of all the businesses in which the banking organization is engaged and provides a useful point of comparison to AUC. Accordingly, an

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[9] An income-based approach would increase reporting burden for banking organizations subject to the supplementary leverage ratio because banking organizations currently do not report income from custodial, safekeeping, and asset servicing activities separately from income derived from fiduciary activities. An absolute amount measure also would be inappropriate because such a measure would only take the scale of the banking organization's custodial, safekeeping, and asset servicing activities into account, instead of considering the predominance of these activities relative to the banking organization's other activities.

AUC-to-total assets ratio provides a measure of the extent to which a banking organization is predominantly engaged in custody, safekeeping, and asset servicing activities. Commenters that supported the proposal also supported the use of the AUC-to-total assets measure to define a custodial banking organization.

Staff analysis demonstrated a clear separation between the lowest observed AUC-to-total assets ratios of The Bank of New York Mellon, Northern Trust Corporation, and State Street Corporation[10] and the highest observed AUC-to-total assets ratios among other advanced approaches banking organizations. An AUC-to-total assets ratio of 30:1 is approximately equal to the midpoint of the range between the minimum observed for The Bank of New York Mellon, Northern Trust Corporation, and State Street Corporation (52:1) and the maximum observed for the other advanced approaches banking organizations (9:1), over the period from the second quarter of 2016 through the second quarter of 2019. An AUC-to-total asset ratio of 30:1 also is less than the minimum estimated ratio for The Bank of New York Mellon, Northern Trust Corporation, and State Street Corporation (35:1) over the period from 2004 through the second quarter of 2019, which includes the 2007-2009 financial crisis. The use of a four-quarter average further serves to minimize the impact of volatility in a banking organization's AUC-to-total assets ratio.

Under the final rule, a custodial banking organization may exclude deposits placed at a "qualifying central bank" from the denominator of the supplementary leverage ratio to the extent

[10] The legislative history of section 402 suggests that members of Congress recognized these three institutions as custodial banking organizations. See, e.g., 115 Cong. Rec. S1714 (Mar. 14, 2018) (statement of Sen. Warner) ("Section 402 provides relief to only three banks: Bank of New York Mellon, State Street, and Northern Trust . . . This provision does not mean that, if a bank has a large custodial business, it should get relief . . . ."); 115 Cong Rec. S1659 (Mar. 13, 2018) (statement of Sen. Heitkamp) ("Under the plain reading of [S.2155], the three custody banks are the only three institutions that are predominantly engaged in the custody business.").

that the deposits are linked to fiduciary or custody and safekeeping accounts. Similarly, any subsidiary depository institution of a U.S. top-tier depository institution holding company that qualifies as a custodial banking organization would exclude from total leverage exposure all deposits with a qualifying central bank that are recognized on its consolidated balance sheet in the same manner as its parent depository institution holding company. The final rule therefore would not require such a subsidiary depository institution to satisfy separately a ratio of AUC-to-total assets in order to utilize the exclusion.

B. Mechanics of the Central Bank Deposit Exclusion

Consistent with section 402, under the final rule, the amount of central bank deposits eligible for exclusion from the supplementary leverage ratio equals the average daily balance over the reporting quarter of all deposits placed with a "qualifying central bank" that includes a Federal Reserve Bank, the European Central Bank, or a central bank of an OECD member if the member meets certain criteria.[11] All deposits placed with a Federal Reserve Bank could qualify for the central bank deposit exclusion, including deposits in a master account, deposits in a term deposit account that offers an early withdrawal feature, and deposits in an excess balance account. Any deposits with a qualifying central bank that are denominated in a foreign currency should be measured in U.S. dollars to determine the amount of the deposits that could be excluded from the supplementary leverage ratio.

C. Central Bank Deposit Exclusion Limit

Consistent with section 402, under the final rule, the amount of central bank deposits that can be excluded from the denominator of the supplementary leverage ratio are limited by the on-

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[11] Under section 402, the term "central bank" includes the central banks of an OECD member if the member country receives a zero percent risk weight under section 32 of the capital rule and the sovereign debt of such member country is not in default or has not been in default during the previous five years.

balance sheet deposit liabilities of the custodial banking organization that are linked to fiduciary or custody and safekeeping accounts. Specifically, a custodial banking organization may exclude from its total leverage exposure the lesser of: (1) the amount of central bank deposits placed at qualifying central banks by the custodial banking organization (including deposits placed by consolidated subsidiaries); and (2) the amount of on-balance sheet deposit liabilities of the custodial banking organization (including consolidated subsidiaries) that are linked to fiduciary or custodial and safekeeping accounts. The final rule defines a fiduciary or custodial and safekeeping account as an account administered by a custodial banking organization in its capacity as a fiduciary or custodian, as authorized by applicable federal and state law. A deposit account is considered linked to a fiduciary or custodial and safekeeping account if the deposit account is provided to a client that maintains a fiduciary or custodial and safekeeping account with the custodial banking organization and the deposit account is used to facilitate the administration of the fiduciary or custody and safekeeping account.

Conclusion:

FDIC staff are requesting the FDIC Board approve the attached interagency final rule and authorize its publication in the *Federal Register* with an effective date of April 1, 2020.

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