July 21, 2023

Via email: comments@fdic.gov

James P. Sheesley
Assistant Executive Secretary
Attention: Comments/RIN 3064-AF93
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429

Re: Special Assessments Pursuant to Systemic Risk Determination

Ladies and Gentlemen:

The Bank of New York Mellon Corporation, the Northern Trust Corporation, and State Street Corporation (collectively, the **Custody Banks**) welcome the opportunity to comment on the proposed rulemaking, *Special Assessments Pursuant to Systemic Risk Determination* (the **Proposed Rule**), issued by the Federal Deposit Insurance Corporation (the **FDIC**) on May 11, 2023. Our collective status as among the largest providers of global custody services and our resulting unique liquidity profile informs our perspective on the Proposed Rule.

The Custody Banks appreciate the crucial role the FDIC's Deposit Insurance Fund (the **DIF**) plays in providing stability to the banking system and the Custody Banks commend the FDIC's swift actions to stabilize the system in the wake of the failures of Silicon Valley Bank (**SVB**) and Signature Bank (**SBNY**). The failures of SVB and SBNY (the **Recent Bank Failures**) highlight the importance of the authority provided to the FDIC, in conjunction with the Board of Governors of the Federal Reserve System (**Federal Reserve**) and the United States Treasury, on an exceptional basis, to extend its coverage to uninsured deposits, and we support a special assessment on banks above a certain size to recover the losses sustained by the DIF (the **Special Assessment**). We write, however, to share reservations about the Proposed Rule because it would have a disproportionate and unwarranted impact on the Custody Bank business model and set a poor precedent for sound asset-liability and risk management.

The Custody Banks strongly urge the FDIC to retain the regular risk-based assessment methodology as the basis for the Special Assessment, while maintaining the exclusion of the first $5 billion in estimated uninsured deposits to exempt small banks. The proposed Special Assessment base (the **Proposed Base**), consisting *solely* of uninsured deposits, would be unprecedented. Notwithstanding the exceptional circumstances of the failures of SVB and SBNY, it is important to maintain a consistent, predictable approach to determining deposit insurance assessments that allows banks to manage their businesses, financial risks, and balance sheets accordingly. The existing risk-based assessment methodology is the better approach to properly incentivize stable funding sources, liquid asset composition appropriately calibrated to a bank's liability structure, and prudent asset-liability management.

If, however, the FDIC does not retain the regular risk-based assessment base, the Custody Banks urge the FDIC to consider alternative adjustments to account for deposit stability, funding structure, and asset quality. These revisions to the proposed assessment methodology[1] would better incentivize good risk management and properly accounts for the unique business model of the Custody Banks.

First, in recognition that cash placed at central banks is insulated from credit, market, and liquidity risks, and is therefore available to meet unexpected depositor withdrawals upon demand, the Custody Banks should be permitted to exclude from the Proposed Base an amount equal to their domestic deposit balances placed with the Federal Reserve.

Alternatively, the Custody Banks should be permitted to deduct 75% of their domestic operational deposits[2] from the Proposed Base as recognized in the LCR rule and other liquidity regulations.

These alternatives would not be without precedent as the FDIC and other banking agencies have previously recognized adjustments for conservative asset-liability management strategies to support custody-related activities.[3]

Our comments are explained in more detail below.

I. Background on the Recent Bank Failures

As the FDIC recognizes in its Proposed Rule, it is necessary to consider the circumstances which led to the Recent Bank Failures in order to fairly apportion the burden of the Special Assessment.

Following the failures of SVB and SBNY, the Federal Reserve as well as the California Department of Financial Protection and Innovation and the New York State Department of Financial Services, each conducted post-mortem reviews of their supervision of those banks. As each agency recognized in their reports, SVB and SBNY experienced runs and failed primarily because of poor interest rate risk and asset-liability management. Those risks were further exacerbated by the failures of management at SVB and SBNY to fully appreciate the nature of their deposit bases.

Deposit insurance assessment methodologies should as a result recognize and incentivize prudent interest rate risk and asset-liability management. Furthermore, the FDIC's focus on large banks with large amounts of uninsured deposits does not take into account the important differences between the Custody Bank business model and other bank business models, as well as the fact that many uninsured deposits are stable.

[1] We refer to an assessment base, the applicable assessment pricing method, and the applicable assessment rate collectively as the **assessment methodology**.

[2] We use the term "operational deposit" as defined in the Liquidity Coverage Ratio (**LCR**) and the Net Stable Funding Ratio (**NSFR**) rules. *See* 12 C.F.R. § 249.4(b) ("Operational deposit means unsecured wholesale funding or a collateralized deposit that is necessary for the [BANK] to provide operational services as an independent third-party intermediary, agent, or administrator to the wholesale customer or counterparty providing the unsecured wholesale funding or collateralized deposit."). *See also* 12 C.F.R. § 329.3 (similar definition).

[3] *E.g.*, the LCR, NSFR, and Supplementary Leverage Ratio (**SLR**) rules.

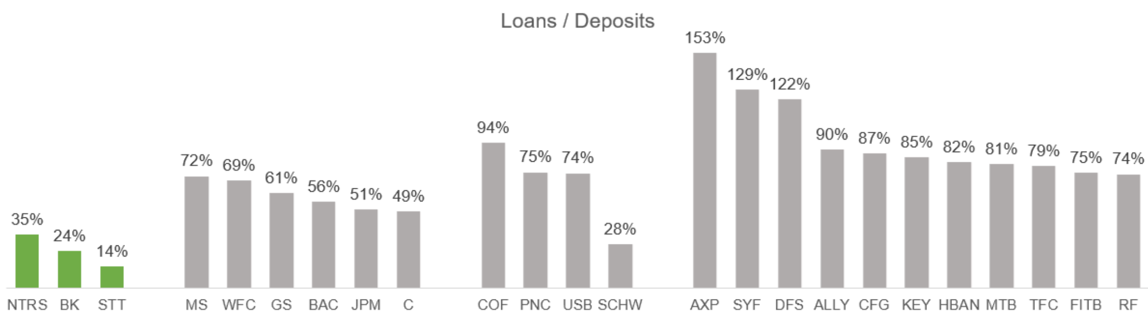
II. The Custody Bank Business Model

Fee-Based Business

The Custody Banks employ a fee-based business model focused on the provision of operational services, such as safekeeping, settlement, asset administration, and trust and banking services, to institutional customers. The Custody Bank client base is diverse and includes regulated investment funds, which are often required to use a custody bank under their prevailing regulatory regime. In other cases, the use of a custodian bank reflects well-established client preference to safe-keep investment portfolios with banking entities that are subject to stringent prudential requirements and regulatory oversight.

Liability-Driven Balance Sheet

Custody Bank balance sheets are structured differently from other banks with extensive commercial and investment banking operations. The Custody Bank balance sheet is liability-driven and expands not through asset growth but through the organic development of client-servicing relationships that, over time, translate into increased volumes of stable uninsured deposits. These uninsured deposits, rather than representing other sources of wholesale funding, comprise the largest part of a Custody Bank's liabilities. Importantly, Custody Banks generate deposit liabilities as a direct result of the financial services they provide. In other words, the cash deposits that come on to the Custody Bank balance sheet are driven by customer-related needs and not by the bank's financing decisions. The liabilities-driven nature of a Custody Bank's balance sheet is reflected in part by the Custody Banks' low loan to deposit ratios as shown below.



Source: FFIEC 031 (12/31/2022)

Highly Liquid Asset Composition

Custody Banks also have a highly liquid asset-side of their balance sheets. Stable deposit liabilities are used to fund certain banking services for clients, such as the extension of intra-day and overnight credit and the purchase of well-diversified portfolios of high-quality liquid assets which generate conservative amounts of net interest revenue and serve as sources of liquidity through use as collateral at financial market utilities.

We believe that the Proposed Base should take these factors into account while remaining fair and equitable to all banks. The Custody Banks therefore recommend that the FDIC use the existing regular assessment base in calculating the Special Assessment, as discussed in further detail below.

III. The FDIC Should Use Each Bank's Existing Regular Assessment Base

The existing risk-based assessment methodology (*i.e.*, the current applicable assessment base and assessment pricing methodology) appropriately takes into account the unique balance sheet characteristics of banks that are engaged in providing custody and related services and properly incentivizes sound asset-liability management. Because banks routinely and prudently manage their balance sheets to account for the applicable assessment methodology, a bank's regular assessment base already reflects the bank's management of its balance sheet risks. The Custody Banks therefore urge the FDIC to use the regular assessment base for the purposes of the special assessment, or, at a minimum, to adjust the Proposed Base to incorporate key aspects of the regular assessment that recognizes the unique Custody Bank business model.

FDIC Discretion

The FDIC is granted wide latitude by the Federal Deposit Insurance Act to design special assessments, while taking into account the types of entities that benefit from a systemic risk determination, economic conditions, industry effects, and other factors. In this case there are no compelling reasons to depart from the existing risk-based assessment methodology. For instance, it is unclear whether an assessment methodology based on uninsured deposits, as opposed to the existing risk-based methodology, would be fairer, especially when accounting for the distinctions between different types of uninsured deposits and the relatively greater stability of the Custody Banks' balance sheets.

Proper Incentives for Risk Management

The existing risk-based assessment methodology provides good incentives for proper risk management. Under the methodology, banks operating in business-as-usual environments are incentivized to better manage the stability of their deposit base and to align their deposits with appropriately liquid assets. For example, a bank with a highly runnable deposit base is safer if it holds high quality liquid assets with limited duration than if it holds long-term assets with longer maturities. Another example relates to banks that are dependent on brokered certificates of deposit or high-yield savings accounts. Although these deposits may be FDIC-insured, they are still less stable and create greater potential interest rate risk on the asset side of the balance sheet. A risk-based methodology would properly recognize the variability of these scenarios and accordingly result in a higher deposit assessment for the riskier banks.

Proper Incentives for Recovery and Resolution

A risk-based methodology is also good for gone concern banks because it incentivizes banks to hold more high-quality, short duration, liquid assets (*e.g.*, cash at central banks). This means that a bank in a resolution scenario would have more "good" assets on hand to liquidate and use to pay depositors, ultimately reducing the costs that would be incurred by the DIF.[4]

Congressional Intent and Precedent

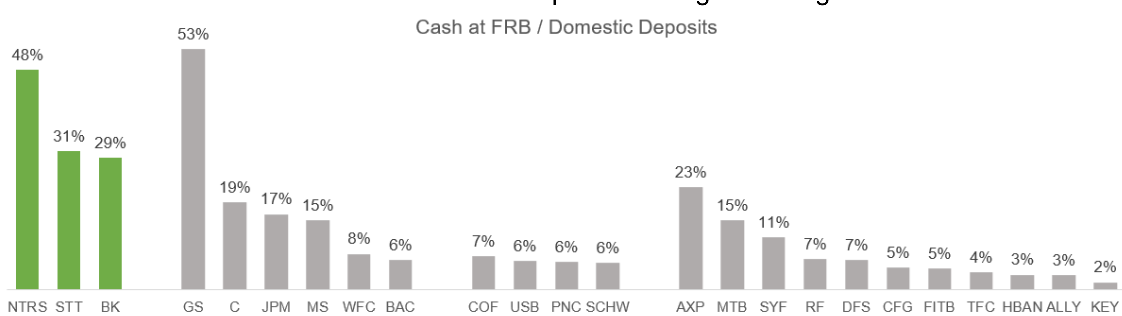
Congress recognized through the Dodd-Frank Act that the previous deposit-based assessment methodology did not incentivize good risk management and therefore required the FDIC to adopt an appropriately risk-sensitive asset-based alternative. In response, the FDIC adopted, with certain changes over time, the existing regular assessment methodology to replace the previous deposit-based methodology. The existing regular assessment methodology therefore reflects Congress' judgment that the use of risk-based metrics is a better approach to determining the allocation of costs to the DIF.

[4] Although we do not expect to ever encounter a resolution scenario requiring the execution of our living wills, we note that we have prepared and refreshed these plans on a regular basis for nearly a decade and continue to do so. Our living wills provide detailed strategies for our orderly resolution to preserve value, provide continuity of services, and avoid systemic risk to the financial system while ensuring depositors have timely access to their insured deposits without any cost to the DIF. Our plans do not contemplate any extraordinary funding or public support such as a systemic risk determination.

Systemic Risk Determination
We believe that the banking system as a whole benefited from the systemic risk determination in the wake of the Recent Bank Failures and not primarily the largest banks, much less the Custody Banks. Indeed, deposit inflows into the Custody Banks following the Recent Bank Failures were relatively modest and, as excess deposits, could not have been deployed by the Custody Banks for any material economic gain. As a result, the existing regular assessment methodology already fairly and appropriately considers the risks posed to the banking system by different types of depository institutions and their respective risk profiles in apportioning the costs sustained by the DIF. Maintaining the existing methodology for the special assessment would therefore recognize lower risk business models with conservative asset-liability management practices and stable deposits, including the Custody Bank business model. Further, all banks would benefit from the consistent use of the existing deposit insurance assessment methodology and the predictability it provides for the management of their businesses, financial risks, and balance sheets.

IV. Alternatively, the Custody Banks Should Be Allowed to Exclude Funds Deposited with the Federal Reserve

As discussed above, the Custody Banks predominantly engage in fiduciary, safekeeping, and asset servicing activities. Our institutional clients maintain cash deposits in connection with these services, which—apart from the balances represented by operational deposits—fluctuate depending on market conditions and client needs. For example, funds awaiting investment or distribution are often held in the form of cash on deposit, and such balances tend to increase during periods of market stress or uncertainty as clients seek to manage their own risk. The Custody Banks typically address excess cash deposits in the most conservative way possible through overnight placements at central banks; we maintain some of the highest ratios of cash held at the Federal Reserve versus domestic deposits among other large banks as shown below.



Source: FFIEC 031; FR Y-9C (12/31/2022)

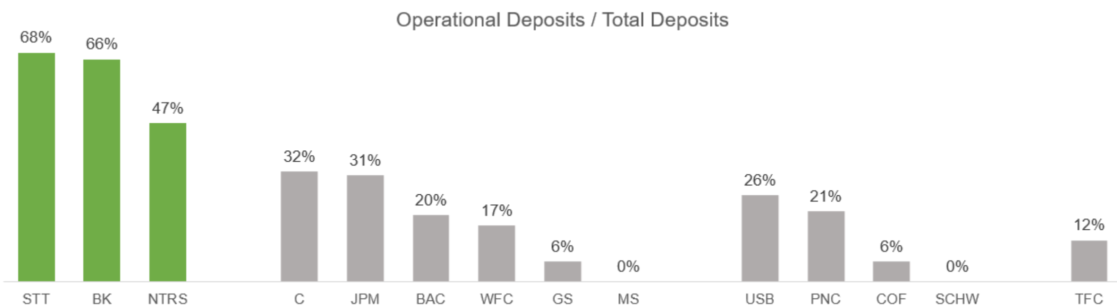
This approach carries little-to-no credit, market, interest rate, and operational risk so that cash is on hand to meet client demands. Excluding such cash from the Proposed Base would better recognize that deposits supported by central bank placements do not require deposit insurance.

We therefore recommend that the Custody Banks be permitted to deduct from the Special Assessment base all deposits held in their master accounts at the Federal Reserve. These excess cash deposits represent general assets of the bank which can be used without limitation to satisfy specific liabilities. Because these deposits are held with the Federal Reserve, they are readily available to cover liabilities of the bank in the event of failure and thus would not incur any cost to the DIF. This deduction would be similar to other deductions for custody banks in prudential regulation (*e.g.*, the SLR exclusion of certain central bank deposits).

V. Alternatively, the Custody Banks Should Be Allowed to Subtract a Portion of Their Operational Deposits from the Proposed Base

Background on Operational Deposits

The Custody Banks hold residual cash for their clients in deposit accounts to facilitate day-to-day transactional activities related to client investment assets (*i.e.*, **operational deposits**). For example, deposit accounts are used to settle trades, collect and disburse income and dividend payments, the proceeds from maturing assets, the processing of corporate action events, tax reclamations, and the payment of fees and expenses. Unlike many other types of wholesale funding, operational deposits have proven to be stable, predictable, and a steady source of funding over the long term. Indeed, a significant portion of uninsured deposits held at the Custody Banks are stable operational deposits (comprising roughly one-half to two-thirds of all deposits at the Custody Banks), which is materially higher than that of other banks. It is this stable source of funding that forms the basis of the Custody Bank business model and defines its liquidity profile—and not the search for assets with particular yields or returns.



Source: FFIEC 031; Liquidity Coverage Ratio Disclosure (12/31/2022)

As defined by the Basel Committee on Banking Supervision, and consistent with the U.S. federal banking agencies' definition, operational deposits are limited to deposits that result from the provision of clearing, custody, and cash management services (collectively, **operational services**), where the client receiving these services must "place or leave deposits with a bank in order to facilitate their access (to) and ability to use payment and settlement services, and otherwise make payments."[5] Furthermore, and unlike other categories of deposit liabilities, operational deposits must meet a series of stringent requirements to be considered an operational deposit for the purposes of the U.S. federal banking agencies' LCR (and NSFR) rule. Under the LCR rule, these requirements include:

- The operational service must be provided pursuant to a legally binding written agreement, subject to a minimum termination period of 30 days or significant "contractual termination costs or switching costs";
- The deposit must be held in an account that is specifically designated as an operational account;
- The client must hold the deposit with the banking entity for the "primary purpose of obtaining the operational services provided by the [banking entity]";
- "The deposit account must not be designed to create an economic incentive for the customer to maintain excess funds" on deposit with the banking entity;

[5] Basel Committee on Banking Supervision, Basel III: The Liquidity Coverage Ratio and Liquidity Risk Monitoring Tools, ¶ 93 (January 2013).

- "The [banking entity] must demonstrate that the deposit is empirically linked to the operational service and that it has a methodology . . . for identifying any excess amount," which must be excluded from operational deposits;
- The exclusion of deposits resulting for the provision of either prime brokerage services or correspondent banking services, as well as the exclusion of "operational services provided to any non-regulated fund"; and
- The deposits must not be held for another banking entity that temporarily places excess funds in an overnight deposit with the banking entity.[6]

Because the requirements for recognizing operational deposits specifically exclude any balances in excess of those required for the provision of operational services, the federal banking agencies require U.S. banks, as a supervisory matter, to implement detailed and empirically-driven processes for the identification of their operational deposit balances. This is reflected in the use of highly granular methodologies designed to determine deposit amounts that each client is expected to hold in support of its day-to-day transactional needs. These methodologies rely on historical data to identify a client's average daily deposit balance, which is then compared to similar client data in order to conservatively estimate core deposits. Importantly, given their crucial role in supporting normal course investment activities, core deposits cannot be removed from a Custody Bank without the risk of significant disruption to essential payment, clearing, and settlement functions.

The operational deposit modeling processes employed by the Custody Banks are robust and result in the identification of certain "excess amounts" of deposits, which although derived from operational services, are categorized for purposes of the LCR (and NSFR) as non-structural funding. These excess deposits are managed by the Custody Banks in the safest way possible through overnight placements at the Federal Reserve and other national central banks.

As a result of the above multi-layered approach, there is substantial empirical evidence that a significant proportion of the deposit balances held by the Custody Banks are stable over a multi-year horizon, thereby resulting in a robust structural liquidity position with high levels of resilience against potential systemic instability and runs.

<u>Subtracting 75% of Operational Deposits from the Proposed Base is Appropriate and Fair</u>
As noted above, not all uninsured deposits are equal. The FDIC itself has recognized that operational deposits are different from other uninsured deposits. For instance, the FDIC states in the LCR rule preamble that operational deposits held at custody banks "present less liquidity risk during a stress period" and "are more stable than non-operational funding."[7] Similarly, "transaction accounts associated with fiduciary and custody and safekeeping assets," i.e., operational deposits, "generally display the characteristics of core deposits."[8] In light of the inherent stickiness of operational deposits and their low risk of runs, it is appropriate for the Custody Banks to subtract 75% of domestic operational deposits from the Proposed Base (mirroring the 25% haircut for operational deposits under the LCR rule).

Such an adjustment would be a narrow recognition of the more stable nature of operational deposits compared to other uninsured deposits. This would also be consistent with precedent, as the Custody Banks already calculate adjustments on the basis of their operational deposits under

[6] 12 C.F.R. § 249.4(b) (Federal Reserve version of LCR rule).
[7] Liquidity Coverage Ratio: Liquidity Risk Measurement Standards, 79 Fed. Reg. 61439, 61497–98 (Oct. 10, 2014).
[8] Assessments, Large Bank Pricing, 76 Fed. Reg. 10671, 10680 (Feb. 25, 2011).

the LCR and NSFR rules. Though operational deposits are not currently broken out in banks' reporting, it would be straightforward to calculate and report such deposits going forward.

VI. Conclusion

Thank you once again for the opportunity to comment on the important matters raised within the Proposed Rule. To summarize, while the Custody Banks support the imposition of the Special Assessment to recover losses sustained by the DIF, we believe that this should be done using the existing regular assessment base rather than using a novel methodology based on levels of uninsured deposits. We believe there are strong reasons to do so, including incentivizing good asset-liability and risk management and providing for predictability and consistency. Alternatively, we recommend that the FDIC allow the Custody Banks to exclude from the Special Assessment base cash held with the Federal Reserve in recognition of the conservative risk profile and highly-liquid nature of such assets. As another alternative approach that would properly recognize and incentivize stable funding sources, prudent asset-liability management practices, and the low-risk nature of the Custody Banks' business model, we recommend the FDIC adopt a deduction for the Custody Banks from the Special Assessment base equal to 75% of their respective total domestic operational deposits.

Should you have any questions or require any additional information, please do not hesitate to contact anyone listed below:

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