March 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 is seeking the approval of the Federal Deposit Insurance Corporation (FDIC) Board of Directors (FDIC Board) to publish the attached interagency notice of proposed rulemaking (proposal or NPR) 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: Staff recommends that the FDIC Board approve the interagency NPR and authorize its publication in the *Federal Register* with a public comment period that closes 60 days after publication.

Concur:

Charles Yi
General Counsel

Discussion:

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 custodial clients, for example, deposit balances generally increase during periods when customers sell securities. To manage these fluctuations, banking organizations may maintain significant cash deposits at central banks. Under U.S. GAAP, central bank deposits are on-balance sheet assets for such organizations.

Under the capital rule, advanced approaches banking organizations[1] must maintain a supplementary leverage ratio of 3 percent. 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.[2] In addition, the largest and most interconnected U.S. bank holding companies must maintain an enhanced supplementary leverage ratio (eSLR) of 5 percent (comprised of the 3 percent minimum supplementary leverage ratio requirement and a leverage capital buffer requirement of 2 percent) to avoid limitations on

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[1] Currently, an advanced approaches banking organization is defined as a depository institution holding company with consolidated total assets of at least $250 billion or at least $10 billion in foreign exposure and any of its depository institution subsidiaries. The agencies recently proposed revisions to the capital rule that would amend these thresholds and would tailor the application of capital requirements based on an institution's risk profile. The proposal would affect the scope of application of the supplementary leverage ratio. See 83 FR 66024 (December 21, 2018).

[2] 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).

capital distributions and certain discretionary bonus payments.[3] An IDI subsidiary of a bank holding company subject to the eSLR must have an eSLR of 6 percent to be considered "well capitalized" under the agencies' prompt corrective action framework.[4]

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[5] 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.[6] 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).[7] 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."[8]

II. Proposal

A. Scope of Applicability

Staff interpret the phrase "predominantly engaged in custodial, safekeeping, and asset

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[3] See 79 FR 24528 (May 1, 2014).
[4] 12 CFR 6.4 (OCC); 12 CFR 208.42 (Board); 12 CFR 324.403 (FDIC).
[5] Section 402 defines a custodial bank to include both a depository institution holding company predominantly engaged in custody, safekeeping, and asset servicing activities, and any IDI subsidiary of such a holding company.
[6] P.L. 115-174, § 402(b)(2)(B).
[7] 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).
[8] § 402(a).

servicing activities" 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.[9] Under the proposal, a depository institution holding company would be considered "predominantly engaged in custody, safekeeping, and asset servicing activities" if the U.S. top-tier depository institution holding company in the organization has a ratio of assets under custody (AUC)-to-total assets of at least 30:1. AUC would equal 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 would equal the average of the U.S. top-tier depository institution holding company's total consolidated assets for the four most recent calendar quarters.

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.[10] Staff propose to use the AUC-to-total assets

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[9] 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").

[10] 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.

measure to define a custodial banking organization because it provides 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 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.

A standard of AUC-to-total assets of 30:1 is proposed because staff's 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[11] and the highest observed AUC-to-total assets ratio among other advanced approaches banking organizations. An AUC-to-total asset 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 third quarter of 2018. An AUC-to-total asset ratio of 30:1 also is less than the

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[11] 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.").

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 third quarter of 2018, 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 proposal, a custodial banking organization would exclude deposits placed at a "qualifying central bank" from the denominator of the supplementary leverage ratio to the extent that they 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 proposal 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. The NPR would also seek comment on extending the proposal to cover depository institutions not controlled by a depository institution holding company.

B. Mechanics of the Central Bank Deposit Exclusion

Consistent with section 402, the amount of central bank deposits eligible for exclusion from the supplementary leverage ratio would equal 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.[12] 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

[12] 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.

feature, and deposits in an excess balance account. Any deposits with a qualifying central bank that are denominated in a foreign currency would 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, the amount of central bank deposits that could be excluded from the denominator of the supplementary leverage ratio would be limited by the on-balance sheet deposit liabilities of the custodial banking organization that are linked to fiduciary or custody and safekeeping accounts. Specifically, a custodial banking organization would be able to 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 proposal would define 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 would be 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 recommends that the FDIC Board approve the attached interagency NPR and authorize its publication in the *Federal Register* with a public comment period that closes 60 days after publication.

Staff Contacts:

RMS

Benedetto Bosco	ext. 8-6853
Michael Maloney	ext. 8-6516
Dushan Gorechan	ext. 8-6584
Keith Bergstresser	ext. 8-3604

Legal

Michael Phillips	ext. 8-3581
Catherine Wood	ext. 8-3788