ALERT MEMORANDUM

Agencies Propose Supplementary Leverage Ratio Relief for Custodial Banks

Proposal Would Implement 2018 Regulatory Relief Legislation

April 5, 2019

On March 29, 2019, the FDIC released a joint proposal with the other federal banking agencies to modify the supplementary leverage ratio requirement to permit "custodial banks" to exclude certain central bank deposits from the denominator of the SLR. The Proposal would implement section 402 of the Economic Growth, Regulatory Relief and Consumer Protection Act, enacted in May 2018. Section 402 requires the Agencies to amend their rules on the SLR to provide relief to banking organizations "predominantly engaged in custody, safekeeping and asset servicing activities."

The Proposal would implement Section 402 without broadening its application beyond the three largest U.S. custody banks—Bank of New York Mellon, State Street and Northern Trust.

The Proposal does not address the Agencies' pending proposal (from April 2018) to recalibrate the "enhanced" supplementary leverage ratio with respect to G-SIBs to include a buffer of half the applicable G-SIB surcharge rather than the 2-3% buffer currently applied over the 3% SLR minimum. Moreover, the Proposal would not revise the SLR-based requirements in the Federal Reserve's total loss-absorbing capacity standard, although the Agencies request comment on whether the proposed relief should be broadened accordingly.

This Alert Memorandum includes two parts:

- A high-level overview of the Proposal, and
- "Key Takeaways," which address the Proposal's expected impact and its interplay with other regulatory initiatives.

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Overview of Proposal

I. Background

— The Proposal[1] implements section 402 ("Section 402") of the Economic Growth, Regulatory Relief and Consumer Protection Act ("Relief Act"), enacted in May 2018, which directs the federal banking agencies (the "Agencies") to amend their capital rules[2] such that "funds of a custodial bank that are deposited with a central bank shall not be taken into account when calculating the supplementary leverage ratio as applied to the custodial bank."[3]

— Section 402 defines "custodial bank" as any depository institution holding company "predominantly engaged in custody, safekeeping, and asset servicing activities," including any insured depository institution ("IDI") of such a holding company.

II. Central Bank Deposit Exclusion

— *In general.* Consistent with Section 402, the Proposal would revise the supplementary leverage ratio ("SLR") to exclude from its denominator (total leverage exposure) certain central bank deposits of a Custodial Banking Organization or a Custody Bank (each as defined below).

- Under U.S. Generally Accepted Accounting Principles, central bank deposits are on-balance sheet assets of a banking organization.

— *Excluded deposits.* The Proposal would exclude from the SLR denominator of a Custodial Banking Organization or Custody Bank the amount of funds that the Custodial Banking Organization or Custody Bank has on deposit with a "qualifying central bank" ("Deposit Exclusion"), subject to the limitation described below.

- Consistent with Section 402, the Proposal defines "qualifying central bank" as a Federal Reserve Bank, the European Central Bank or a central bank of a member country of the Organisation for Economic Cooperation and Development ("OECD"), provided that an exposure to the OECD member country receives a zero percent risk weight under the Capital Rules and the sovereign debt of such member country is not in default and has not been in default within the previous five years.

- For purposes of the Deposit Exclusion, central bank deposits recognized on the consolidated balance sheet of a Custodial Banking Organization or Custody Bank may include deposits made with a central bank by a consolidated foreign subsidiary depository institution, although such a subsidiary would not itself be a Custodial Banking Organization or a Custody Bank.

- The Proposal's preamble notes that the Deposit Exclusion "would equal the average daily balance over the reporting quarter of all deposits placed with a 'qualifying central bank.'" However, the proposed regulation itself does not prescribe a calculation methodology for the Deposit Exclusion, and the Agencies specifically request comment on how the regulation should describe the calculation to facilitate the Deposit Exclusion.

— *Limitation.* Consistent with Section 402, the Proposal would limit the amount of central bank deposits that count toward the Deposit Exclusion to an amount equal to the on-balance sheet deposit

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1 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 (released by the Federal Deposit Insurance Corporation ("FDIC") Mar. 29, 2019), https://www.fdic.gov/news/board/2019/2019-03-29-notice-dis-a-fr.pdf. The Office of the Comptroller of the Currency ("OCC") and the Board of Governors of the Federal Reserve System ("Federal Reserve" and, together with the FDIC and OCC, the "Agencies") have not yet approved the Proposal but are expected to do so shortly.

2 12 C.F.R. Parts 3 (OCC), 217 (Federal Reserve) and 324 (FDIC) (collectively, the "Capital Rules").

3 Pub. L. 115-174 (enacted May 24, 2018).

liabilities of the Custodial Banking Organization or Custody Bank that are linked to fiduciary or custodial and safekeeping accounts.

- The Proposal would define "fiduciary or custodial and safekeeping account" as an "account administered by a [Custodial Banking Organization or Custody Bank] for which the [Custodial Banking Organization or Custody Bank] provides fiduciary or custodial and safekeeping services, as authorized by applicable federal or state law."[4]
- The mere fact that a client has both a deposit account and a fiduciary or custodial and safekeeping account at the same Custodial Banking Organization or Custody Bank would not be sufficient to "link" the two accounts for purposes of the Deposit Exclusion. As explained in the preamble to the Proposal, a deposit account would be considered "linked" to a fiduciary or custodial and safekeeping account if the deposit account "is used to facilitate the administration of the fiduciary or custody and safekeeping account,"[5] such as an account used to process interest and dividend payments or other transactions related to securities held in the fiduciary or custodial and safekeeping account.

III. Applicability

— *Coverage.* The Proposal would identify holding companies "predominantly engaged" in custody activities by the ratio of a holding company's total assets under custody ("AUC") to its total assets ("AUC Ratio"). As defined in the Proposal, a "custodial banking organization" would be any depository institution holding company with an AUC Ratio of 30-to-1 or greater ("Custodial Banking Organization") and each of its IDI subsidiaries (each, a "Custody Bank").

- Top-tier banking organizations currently report AUC (the value of all assets held as custodian on behalf of customers) on the FR Y-15, Schedule C each quarter. For purposes of the AUC Ratio, AUC would be calculated as an average over the most recent four calendar quarters.
- Total assets would be calculated as an average over the most recent four calendar quarters.
- As proposed, a Custodial Banking Organization that reports an AUC Ratio of less than 30-to-1 would cease immediately to be eligible for the Deposit Exclusion.
  - The Agencies request comment on whether there should be a "delay" to losing Custodial Banking Organization status, and we expect commenters to request some delay, transition or "cure" period.
- Other methods of determining qualifying banking organizations—such as a custody income ratio method or an absolute value of custody services method—were considered and rejected by the Agencies.

— *IDI subsidiaries.* Consistent with Section 402, any IDI subsidiary of a holding company that meets the required AUC Ratio would not be required to meet the ratio separately.

- The Proposal does not address the possibility that an IDI subsidiary could meet the AUC Ratio when its parent holding company does not (perhaps based on the additional non-custody operations of non-bank subsidiaries of the holding company). The statutory text applies the Deposit Exclusion only to IDIs that are subsidiaries of a Custodial Banking Organization. However, the Agencies indicated that they are considering applying the Deposit Exclusion to IDIs that are not controlled by a holding company. Commenters should consider requesting that the Proposal also be expanded to provide relief to IDIs that meet the AUC Ratio even when their holding companies do not.

4 Proposed 12 C.F.R. §§ 3.2, 217.2 and 324.2.

5 Proposal (FDIC Release), p. 23.

IV. Impact Analysis

— According to the Agencies' impact analysis, the Proposal could provide a material reduction in the leverage capital requirements applicable to the three banking organizations—Bank of New York Mellon, State Street and Northern Trust—that would be eligible for the Deposit Exclusion based on the manner in which the Agencies have defined the scope of Custodial Banking Organizations ("Eligible Banking Organizations").

- The Agencies estimate that the Eligible Banking Organizations have central bank deposits qualifying for the Deposit Exclusion representing approximately 21-30% of their total assets and 20-28% of their total leverage exposure.
- The Agencies estimate that under the Proposal, the amount of tier 1 capital that the Eligible Banking Organizations are required to hold would decrease by approximately $8 billion in aggregate at the top-tier holding company level and $8 billion in aggregate across the lead IDI subsidiaries of these organizations when tier 1 capital is measured only with respect to the SLR—not other capital requirements that may be binding on a banking organization.
- The Agencies' analysis indicates that the SLR is not currently the binding capital requirement for any of the Eligible Banking Organizations that would be eligible for the Deposit Exclusion and thus would not decrease the organizations' required tier 1 capital at the top-tier holding company level.
- However, the SLR is the binding constraint for two IDI subsidiaries of certain of the Eligible Banking Organizations. The Agencies estimate that the Proposal would result in an approximately $7 billion—or 23%—decrease in the amount of tier 1 capital that these two IDIs are required to hold under the current Capital Rules.

V. Comment Period

Comments on the Proposal are due within 60 days of its publication in the Federal Register.

Key Takeaways

Below we highlight key takeaways from the Proposal.

— ***The benefits of the Proposal are limited in applicability but potentially substantial in impact***. The Bank of New York Mellon, State Street and Northern Trust are the only banking organizations that currently meet the requirements to be considered Custodial Banking Organizations under the Proposal and, therefore, would be the only firms able to exclude central bank deposits held in connection with fiduciary and custodial activities from their SLR calculations. No other banking organization comes close to the 30-to-1 AUC Ratio required to benefit from the relief under the Proposal; according to the Proposal, the next highest AUC Ratio for any banking organization subject to the SLR is 9-to-1.

- The legislative history of Section 402 of the Relief Act indicates that Congress intended the statutory relief to apply only to "true custodial banks."[6] Banking organizations that have a large custodial business but also engage in a wide variety of other banking activities appear to have been intentionally excluded from statutory relief and would not qualify under the metrics in the Proposal.

[6] Proposal (FDIC Release), p. 12 (citing 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"); H.R. Rep. No. 115-656, at 3-4 (2018) ("Banks that have a predominant amount of business derived from custodial services are different from banks that engage in a wide variety of banking activities")).

- During the open meeting approving the Proposal, FDIC Board Member Martin Gruenberg expressed strong reservations about the reduction in capital for two firms that he views as essential to the financial market infrastructure when both firms currently meet the SLR requirements and "remain quite profitable." Nevertheless, he voted for the Proposal because it is consistent with the Congressional mandate set forth in Section 402 of the Relief Act.

— ***The benefits of the Proposal are limited to the SLR capital requirement***. The Proposal does not apply to the tier 1 leverage ratio or the total loss-absorbing capacity ("TLAC") requirements that are based on total leverage exposure. The Federal Reserve has discretion to apply the same relief in the TLAC context, but the Proposal did not include any changes to the Regulation YY provisions implementing the SLR-based TLAC requirements. However, the Agencies requested feedback from commenters on whether it is appropriate to extend relief to TLAC requirements as well. In contrast, the Agencies did not ask whether the Proposal should be extended to the tier 1 leverage ratio.

— ***The Proposal does not provide insight into any potential recalibration of the enhanced supplementary leverage ratio ("eSLR")***. On April 11, 2018, the Federal Reserve and the OCC issued a joint notice of proposed rulemaking to modify the eSLR requirements for U.S. top-tier bank holding companies that are identified as G-SIBs and their subsidiary IDIs that are state member banks, national banks or Federal savings associations ("eSLR Proposal"). The eSLR Proposal would replace the 2% buffer for G-SIB holding companies and the 3% buffer for their subsidiary IDIs, with a buffer tailored to half the individually calibrated G-SIB surcharge. The eSLR Proposal also would modify the Federal Reserve's TLAC buffer and leverage-based long-term debt requirements for bank holding companies and the U.S. intermediate holding companies of non-U.S. G-SIBs.

- The eSLR Proposal noted that "significant changes to [either the SLR denominator or the definition of tier 1 capital from then-pending legislative proposals, such as Section 402] would likely necessitate reconsideration of the proposed recalibration as the proposal is not intended to materially change the aggregate amount of capital in the banking system." [7]

— ***The Proposal diverges from the Basel leverage framework.*** The so-called "Basel IV" revisions to the Basel capital framework issued by the Basel Committee on Banking Supervision in December 2017 allow for national discretion to exempt central bank reserves from the leverage ratio exposure measures, but only temporarily and in exceptional macroeconomic circumstances. Basel IV also provides that any such exemption must be accompanied by a corresponding increase in the calibration of the minimum leverage ratio requirement to offset the impact of exempting central bank reserves. In contrast, the Proposal permanently would exempt central bank reserves of Custodial Banking Organizations and Custody Banks that are held in connection with fiduciary and custodial activities.

- The Agencies did not comment on, or even acknowledge, this divergence.
- We expect commenters to urge the Agencies to ensure consistency of global standards by advocating for changes to the Basel leverage framework to ensure competitive equality with respect to the treatment of custodial assets.

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[7] 87 Fed. Reg. 17317, 17319 (Apr. 19, 2018); *see also* Cleary Gottlieb, Federal Reserve Proposes "Stress Capital Buffer" and Scales Bank Enhanced Supplementary Leverage Ratio: An Effort to "Simplify", Nevertheless Adds Complexity (available here).