December 4, 2019

Bank Capital Requirements

Banking Agencies Issue Final Supplementary Leverage Ratio Rule for Custodial Banks

SUMMARY

On November 19, the Federal Reserve, OCC and FDIC jointly issued a final rule to implement Section 402 of the Economic Growth, Regulatory Relief, and Consumer Protection Act ("*EGRRCPA*"), which modifies the supplementary leverage ratio ("*SLR*") in their regulatory capital rules to exclude certain funds of custodial banking organizations deposited with certain central banks.[1] A banking organization is considered a custodial banking organization if it is a U.S. top-tier depository institution holding company with a ratio of assets under custody ("*AUC*")-to-total assets of at least 30 to 1, or a subsidiary depository institution of any such holding company. Under the final rule, a custodial banking organization will exclude deposits placed at a Federal Reserve Bank, the European Central Bank and certain other central banks from its "total leverage exposure" (the denominator of the SLR), subject to a limit on the amount of deposits that can be excluded calculated as the amount of deposit liabilities of the custodial banking organization that are linked to fiduciary or custody and safekeeping accounts.

The final rule is effective April 1, 2020.

BACKGROUND

The generally applicable leverage requirements of the agencies' regulatory capital rules provide that all banking organizations must meet a minimum leverage ratio of 4 percent, measured as the ratio of tier 1 capital to average total consolidated assets. Since January 1, 2018, advanced approaches banking organizations have also been required to maintain an SLR of at least 3 percent.[2] The SLR 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.[3] In addition, U.S. top-tier bank holding

companies ("*BHCs*") that are identified as U.S. global systemically important BHCs ("*G-SIBs*")[4] and their subsidiary insured depository institutions ("*IDIs*") are subject to enhanced SLR ("*eSLR*") requirements. The eSLR currently requires that U.S. G-SIBs maintain a supplementary leverage ratio of at least 5 percent (consisting of the 3 percent minimum and a buffer of 2 percent) in order to avoid limitations on capital distributions and discretionary bonus payments, and that IDI subsidiaries of U.S. G-SIBs have an SLR of at least 6 percent to be considered "well capitalized" under the agencies' prompt corrective action framework.[5] The denominator of the SLR—total leverage exposure—is also used for the leverage-based total loss absorbing capacity ("*TLAC*") and long-term debt ("*LTD*") requirements applicable to U.S. G-SIBs.[6]

In May 2018, EGRRCPA was enacted.[7] Section 402 of EGRRCPA requires the Federal Reserve, OCC and FDIC to amend their rules implementing the SLR to specify that funds of a "custodial bank"[8] that are deposited with a qualifying central bank, including a Federal Reserve Bank or the European Central Bank, will not be taken into account when calculating the SLR denominator, but that any amount so deposited that exceeds the total value of the deposits of the custodial bank that are linked to fiduciary or custodial and safekeeping accounts will be taken into account when calculating the SLR denominator.

KEY ASPECTS OF THE FINAL RULE

The final rule, which was adopted as proposed, amends the regulatory capital rules of the Federal Reserve, OCC and FDIC to require a "custodial banking organization" to exclude deposits with "qualifying central banks" from its total leverage exposure (*i.e.,* the denominator for the SLR), subject to a limit calculated as the amount of funds on deposit at the custodial banking organization that are "linked to" "fiduciary or custodial and safekeeping accounts" at the custodial banking organization.

The agencies explain that during times of stress, a custodial banking organization's custodial clients may liquidate significant volumes of securities, which could result in a significant increase in a custodial banking organization's custodial deposits. Because deposits are on-balance-sheet liabilities, an increase in custodial deposits would ordinarily correspond to an increase in total assets, which, in turn, would result in greater total leverage exposure and a need for a custodial banking organization to hold additional capital to meet SLR requirements. According to the agencies, the final rule mitigates these effects.[9]

- **Statutory definition of "custodial bank" and use of the AUC-to-total assets measure to identify "custodial banking organizations."** Section 402 of EGRRCPA 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." Citing statements from the legislative history of Section 402, the agencies note that the phrase "predominantly engaged in custodial, safekeeping, and asset servicing activities" "suggests that the banking organization's business model is primarily focused on custody, safekeeping, and asset servicing activities, as compared to its commercial lending, investment banking, or other banking activities."[10]
    - Under the final rule, a depository institution holding company will be considered "predominantly engaged in custody, safekeeping, and asset servicing activities"—and identified as a "custodial

banking organization"— if it has a ratio AUC-to-total assets of at least 30:1. AUC and total assets are determined using averages over the four most recent calendar quarters. The use of four-quarter averages is intended to minimize the impact of volatility in a banking organization's AUC-to-total assets ratio.

- According to the agencies, the 30:1 AUC-to-total asset ratio threshold represents approximately the midpoint of the range between (i) the minimum AUC-to-total assets observed for the three banking organizations that the agencies identify qualifying as custodial banking organizations (52:1) and (ii) the maximum observed for other advanced approaches banking organizations (9:1), in each case over the period from the second quarter of 2016 through the third quarter of 2018. The agencies also note that the threshold is below the minimum estimated ratio for any of those three banking organizations over the period from 2004 through third quarter of 2018.[11]
- An IDI is considered a "custodial banking organization"[12] if it is a subsidiary of a holding company that is itself a "custodial banking organization." Under the final rule, an IDI is not required to satisfy separately a ratio of AUC-to-total assets in order to be a custodial banking organization.
- In conjunction with the proposal, the agencies considered alternative measures to identify custodial banking organizations, including an income-based measure using the proportion of a banking organization's income from custodial, safekeeping and asset servicing activities, and absolute measures such as AUC in excess of a specified amount. The agencies explain that they did not propose an income-based measure because banking organizations do not currently separately report income from custodial, safekeeping, and asset servicing activities, and an income-based measure would accordingly increase reporting burdens. The agencies also note that they did not propose an absolute measure because such a measure would reflect only the scale, but not the predominance, of a banking organization's custodial, safekeeping, and asset servicing activities.[13]

- **Definition of "qualifying central bank."** A "qualifying central bank" includes a Federal Reserve Bank, the European Central Bank, or a central bank of an OECD member country if an exposure to the member country receives a zero percent risk weight under the agencies capital rules and the sovereign debt of the member country is not in default and has not been in default during the previous five years.[14]
- **Definition of "fiduciary or custodial and safekeeping account."** The final rule defines a "fiduciary or custodial and safekeeping account" as "an account administered by a custodial banking organization for which the custodial banking organization provides fiduciary or custodial and safekeeping services as authorized by applicable federal and state law." The agencies note that they expect the scope of fiduciary or custodial and safekeeping accounts, as defined in the final rule, not to deviate materially from the current scope of fiduciary and custody and safekeeping accounts reported on Schedule RC-T of the Call Report. However, the agencies clarify that they are not referring directly to schedule RC-T for the scope of fiduciary and custody and safekeeping accounts because holding companies do not report Schedule RC-T of the Call Report.[15]
- **When a deposit account would be considered "linked" to fiduciary or custodial and safekeeping accounts.** A client's maintaining both a deposit account and a fiduciary or custody and safekeeping account at the same custodial banking organization (or one of its affiliates) is not sufficient on its own to establish that the deposits are "linked" to a fiduciary or custodial and safekeeping account. Rather, a deposit account will be considered linked to a fiduciary or custodial and safekeeping account if the client's deposit account "is used to facilitate the administration of the fiduciary or custody and safekeeping account." The agencies provide, as examples, "holding interest and dividend payments related to securities held in the custody or fiduciary account; cash transfers or distributions from the custody or fiduciary account; and the purchases and sale of securities for the account."[16]
- **Central Bank Deposit Exclusion.** A custodial banking organization must 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.[17]

    - A foreign subsidiary's deposits placed with a qualifying central bank would be eligible for the exclusion.[18]
    - The amount of central bank deposits placed at qualifying central banks, and the amount of deposit liabilities linked to fiduciary or custody and safekeeping accounts, will each be determined based on average daily balances over the reporting quarter.
    - All deposits placed with a Federal Reserve Bank will be eligible for the 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.
    - Deposits denominated in a foreign currency would be measured in U.S. dollars for purposes of the exclusion.
- **Effect on leverage-based TLAC and LTD requirements.** The final rule amends the definition of "total leverage exposure" in the regulatory capital rules, which is also used for the leverage-based TLAC and LTD requirements applicable to U.S. G-SIBs. Therefore, the final rule aligns the TLAC rule with the SLR, which the agencies note will reduce "burden by not requiring separate calculations for total leverage exposure under each of the TLAC rule and the supplementary leverage ratio."[19]

Impact Analysis

The agencies estimate that for custodial banking organization holding companies and their lead IDI subsidiaries, central bank deposits eligible for exclusion range from 20 to 28 percent of their total leverage exposure. Taking into account only the exclusion of eligible central bank deposits from total leverage exposure (*i.e.*, disregarding other capital requirements that for a particular institution may act as the binding constraint—for example, the amount of capital necessary for holding companies to pass the quantitative assessment in the Federal Reserve's CCAR stress tests or for IDIs to meet "well capitalized" requirements), the final rule would reduce tier 1 capital requirements (1) by approximately $8 billion in the aggregate across the custodial banking organization holding companies and (2) by approximately $8 billion in the aggregate across their lead IDI subsidiaries.[20]

The agencies estimate, however, that the final rule would not reduce the amount of tier 1 capital that custodial banking organization holding companies are required to hold, taking into account the amount of capital necessary to satisfy applicable leverage, risk-based and post-stress capital requirements. The agencies note that "the final rule would reduce the amount of tier 1 capital that must be maintained by a custodial banking organization holding company only if the supplementary leverage ratio currently serves as the binding capital requirement for the banking organization. Data from the third quarter of 2018 shows that top-tier U.S. depository institution holding companies that are expected to qualify as custodial banking organizations currently are bound by post-stress capital requirements. The risk-based capital standards applicable to these organizations also require a higher amount of tier 1 capital than the amount of tier 1 capital that would be required under the final rule for purposes of the supplementary leverage ratio."[21]

For two IDIs that would be custodial banking organizations, the SLR is currently their binding constraint. The agencies estimate that the final rule will decrease the tier 1 capital requirements for these IDIs by approximately $7 billion, which represents approximately 23 percent of their current tier 1 capital

requirements. Notably, the agencies explain that “[t]he capital standards and other constraints applicable at the custodial banking organization holding company level are expected to limit the amount of capital that such a holding company could distribute outside of the consolidated organization, thus limiting any safety and soundness or financial stability concerns for the holding company as a whole” and that the agencies “have regulatory and supervisory tools to ensure that depository institutions and holding companies maintain appropriate amounts of capital for their operations and risk profile.”[22]

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ENDNOTES

[1] Federal Reserve, OCC, and FDIC, *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* (Nov. 19, 2019), *available at* https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20191119a1.pdf ("*Final Rule*").

[2] Currently, advanced approaches banking organizations generally are depository institution holding companies with total consolidated assets of at least $250 billion or with at least $10 billion in foreign exposure and any of their IDI subsidiaries. In October 2019, the agencies released final rules to tailor how certain aspects of the post-crisis regulatory framework, including SLR requirements, apply to large U.S. banking organizations and foreign banking organizations that have significant U.S. operations. Under the tailoring rules, the SLR will apply to banking organizations subject to Category I, Category II or Category III capital standards, with eSLR requirements applying to Category I banking organizations (*i.e.*, U.S. G-SIBs and their subsidiary IDIs). For further information regarding the tailoring rules, see our Memorandum to Clients: *Regulatory Tailoring for Large Domestic and Foreign Banking Organizations: Banking Agencies Finalize Significant Revisions to the Application of Enhanced Prudential Standards and Capital and Liquidity Requirements to Large U.S. and Foreign Banking Organizations* (Oct. 18, 2019), *available at* https://www.sullcrom.com/files/upload/SC-Publication-Banking-Agencies-Finalize-Tailoring-of-Enhanced-Prudential-Standards-and-Capital-and-Liquidity-Requirements.pdf.

[3] For further information on the SLR, see our Memorandum to Clients: *Bank Capital: Supplementary Leverage Ratio: Federal Banking Agencies Issue Final Rules Revising the Supplementary Leverage Ratio's Exposure Measure Denominator* (Sept. 16, 2014), *available at* https://www.sullcrom.com/siteFiles/Publications/SC_Publication_Bank_Capital_Supplementary_Leverage_Ratio_09_16_14.pdf.

[4] For further information on the Federal Reserve's G-SIB surcharge rule, see our Memorandum to Clients: *Bank Capital Requirements: Federal Reserve Board Approves Final Common Equity Surcharge for U.S. Global Systemically Important Banks* (July 29, 2015), *available at* https://www.sullcrom.com/siteFiles/Publications/SC_Publication_Bank_Capital_Requirements_7_29_2015.pdf.

[5] For further information on the eSLR, see our Memorandum to Clients: *Bank Capital: Supplementary Leverage Ratio: Federal Banking Agencies Propose Revisions to the Supplementary Leverage Ratio's Exposure Measure and Approve Final Rules Implementing an Enhanced Supplementary Leverage Ratio for the Largest U.S. Banking Organizations* (April. 16, 2014), *available at* *https://www.sullcrom.com/siteFiles/Publications/SC_Publication_Bank_Capital_Supplementary_Leverage_Ratio.pdf*.

ENDNOTES (CONTINUED)

In April 2018, the Federal Reserve and the OCC issued a proposal to modify the eSLR requirements for U.S. G-SIBs and their subsidiary IDIs that are state member banks, national banks, or Federal savings associations. The proposal was designed to make the eSLR requirements "more consistent with the risk-based capital measures now in effect for G-SIBs" by (i) changing the eSLR buffer for a U.S. G-SIB from 2 percent to 50% of its risk-based capital surcharge calculated under the Federal Reserve's G-SIB surcharge rule, (ii) supplanting the current 6 percent "well capitalized" SLR threshold with an SLR threshold equal to 3 percent plus 50% of the risk-based G-SIB surcharge applicable to the IDI's U.S. G-SIB holding company, (iii) supplanting the 2 percent TLAC buffer in the Federal Reserve's TLAC rule with a buffer equal to 50% of the U.S. G-SIB's risk-based G-SIB surcharge and (iv) changing the leverage-based LTD requirement for U.S. G-SIBs from 4.5 percent to 2.5 percent plus 50% of the U.S. G-SIB's risk-based G-SIB surcharge. In the April 2018 proposal, the Federal Reserve and OCC noted that the proposal assumed that the components of the SLR would use the current definitions of tier 1 capital and total leverage ratio in their capital rules and that "[s]ignificant changes to either of these components 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." For further information, see our Memorandum to Clients: *Bank Capital Requirements: Federal Reserve and OCC Propose Amendments to the Enhanced Supplementary Leverage Ratio Requirements for U.S. G-SIBs* (Apr. 17, 2018), *available at* https://www.sullcrom.com/siteFiles/Publications/SC_Publication_Bank_Capital_Requirements_04_17_18.pdf.

[6] Federal Reserve, *Total Loss-Absorbing Capacity, Long-Term Debt, and Clean Holding Company Requirements for Systemically Important U.S. Bank Holding Companies and Intermediate Holding Companies of Systemically Important Foreign Banking Organizations*, 82 Fed. Reg. 8266 (Jan. 24, 2017). For further information about the Federal Reserve's TLAC rule, see our Memorandum to Clients: *Loss Absorbency Requirements: Federal Reserve Adopts Final TLAC and Related Requirements for U.S. G-SIBs and U.S. Intermediate Holding Company Subsidiaries of Non-U.S. G-SIBs* (Dec. 16, 2016), *available at* https://www.sullcrom.com/siteFiles/Publications/SC_Publication_Loss_Absorbency_Requirements 12_16_16.pdf.

[7] *See* Economic Growth, Regulatory Relief, and Consumer Protection Act, Pub. L. No. 115-174 (2018), *available at* https://www.congress.gov/115/bills/s2155/BILLS-115s2155enr.pdf. For further information on EGRRCPA, see our Memorandum to Clients: *Financial Services Regulatory Reform Legislation: "Economic Growth, Regulatory Relief, and Consumer Protection Act" Is Enacted* (May 24, 2018), *available at* https://www.sullcrom.com/siteFiles/Publications/SC_Publication_Financial_Services_Regulatory_Reform_Legislation_05_24_18.pdf.

[8] Section 402(a) of EGRRCPA defines "custodial bank" for these purposes 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."

[9] Final Rule at 8; NPR at 18,181.

[10] Final Rule at 9.

[11] Final Rule at 12-13.

[12] The FDIC's and OCC's regulatory capital rules will use the term "custodial bank" instead of "custodial banking organization." Under the final rule, "custodial bank" will generally be defined as an FDIC- or OCC-supervised IDI that is a subsidiary of a depository institution holding company that is a custodial banking organization under the Federal Reserve's capital rules.

[13] Final Rule at 9.

[14] The proposed definition of "qualifying central bank" is substantially the same as the definition of "central bank" in Section 402 of EGRRCPA.

[15] Final Rule at 17-18.

[16] Final Rule at 19.

[17] Final Rule at 19-20.

[18] Final Rule at 15.

ENDNOTES (CONTINUED)

[19] Final Rule at 22.

[20] Final Rule at 23-24.

[21] Final Rule at 24-25.

[22] Final Rule at 25-26.

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