May 10, 2019

Bank Capital Requirements

Federal Reserve, OCC and FDIC Propose Amendments to the Supplementary Leverage Ratio Requirements for Custodial Banking Organizations

SUMMARY

Last week, the Federal Reserve, OCC and FDIC published a joint notice of proposed rulemaking in the Federal Register to implement Section 402 of the Economic Growth, Regulatory Relief, and Consumer Protection Act ("*EGRRCPA*"), which would modify 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 would be 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 proposal, a custodial banking organization would 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 could be excluded calculated as the amount of deposit liabilities of the custodial banking organization that are linked to fiduciary or custody and safekeeping accounts.

Comments on the proposal are due by July 1, 2019.

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 (such as 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. 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.[5]

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.[6] The proposal was designed to make the eSLR requirements "more consistent with the risk-based capital measures now in effect for G-SIBs"[7] 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."[8]

In May 2018, EGRRCPA was enacted.[9] 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"[10] 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 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.

The supplementary information accompanying the proposal to implement Section 402 of EGRRCPA does not reference the Federal Reserve's and OCC's April 2018 proposal regarding the eSLR.

KEY ASPECTS OF THE PROPOSAL

The proposal would amend the regulatory capital rules of the Federal Reserve, OCC and FDIC to allow 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 proposal would mitigate these effects.[11]

- **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 other commercial lending, investment banking, or other banking activities."[12]
  - Under the proposal, a depository institution holding company would 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 would be 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.
  - An IDI would be considered a "custodial banking organization"[13] if it is a subsidiary of a holding company that is itself a "custodial banking organization." The proposal would not require an IDI to satisfy separately a ratio of AUC-to-total assets in order to be a custodial banking organization.
  - 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 did not propose an income-based measure because banking organizations do not currently separately report income from custodial, safekeeping, and asset servicing activities. Accordingly, an income-based measure would increase reporting burdens. The agencies 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.[14]
- **Definition of "qualifying central bank."** A "qualifying central bank" would include 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.[15]

- **Definition of "fiduciary or custodial and safekeeping account."** The proposal would define 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 proposal, not to deviate materially from the current scope of fiduciary and custody and safekeeping accounts reported on Schedule CT-T of the Call Report.[16]
- **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) would not be sufficient on its own to establish that the deposits are "linked" to a fiduciary or custodial and safekeeping account. Rather, a deposit account would 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, using cash deposits "to facilitate processing transactions for the custody or fiduciary account, such as 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."[17]
- **Mechanics of the Central Bank Deposit Exclusion.** 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.[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, would each be determined based on average daily balances over the reporting quarter.
  - All deposits placed with a Federal Reserve Bank would 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.
  - A foreign subsidiary's deposits placed with a qualifying central bank would be eligible for the exclusion.[19]
- **Effect on leverage-based TLAC and LTD requirements.** The proposal would amend 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. Accordingly, for custodial banking organizations that are U.S. G-SIBs, the proposal would also affect their leverage-based TLAC and LTD requirements. Notably, the agencies seek comment on what the advantages and disadvantages are of revising the definition of total leverage exposure for custodial banking organizations solely for purposes of the SLR in the regulatory capital rules compared to revising total leverage exposure for custodial banking organizations in other rules, including the Federal Reserve's TLAC rule.[20]

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 21 to 30 percent of their total assets and 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 satisfy the Federal Reserve's CCAR stress tests or for IDIs to meet "well capitalized" requirements), the proposal 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.[21]

The agencies estimate, however, that the proposal 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 proposal 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 . . . suggests that top-tier U.S. depository institution holding companies that would qualify as custodial banking organizations currently are bound by other post-stress capital requirements."[22]

For two IDIs that would be custodial banking organizations, the SLR is currently their binding constraint. The agencies estimate that the proposal would reduce 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 or allocate for other purposes, 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 constrain the ability of a depository institution to make capital distributions."[23]

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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,* 12 Fed. Reg. 18,175 (Apr. 30, 2019) ("*NPR*").

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 2018 and April 2019, the agencies proposed 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 proposals, SLR requirements would 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 October 2018 and April 2019 proposals, see our Memoranda to Clients entitled *Regulatory Tailoring for Large U.S. Banking Organizations: Federal Bank Regulators Propose Significant Revisions to the Application of Enhanced Prudential Standards and Capital and Liquidity Requirements for Large U.S. Banking Organizations* (Nov. 5, 2018), *available at* https://www.sullcrom.com/files/upload/SC-Publication-Regulatory-Tailoring-for-Large-US-Banking-Organizations.pdf, and *Regulatory Tailoring for Foreign Banking Organizations: Federal Bank Regulators Propose Significant Revisions to the Application of Prudential Standards to Foreign Banking Organizations and Seek Comment on Whether to Impose Standardized Liquidity Requirements on their U.S. Branches and Agencies* (Apr. 23, 2019), *available at* https://www.sullcrom.com/files/upload/SC-Publication-Regulatory-Tailoring-for-Foreign-Banking-Organizations.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 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.

6 OCC, Federal Reserve, *Regulatory Capital Rules: Regulatory Capital, Enhanced Supplementary Leverage Ratio Standards for U.S. Global Systemically Important Bank Holding Companies and Certain of Their Subsidiary Insured Depository Institutions; Total Loss-Absorbing Capacity Requirements for U.S. Global Systemically Important Bank Holding Companies*, 83 Fed. Reg. 17,317 (Apr. 19, 2018) ("*eSLR NPR*"). For additional 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.

7 eSLR NPR at 17,319.

8 eSLR NPR at 17,319.

ENDNOTES (CONTINUED)

[9] *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.

[10] 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."

[11] NPR at 18,179 and 18,181.

[12] NPR at 18,178.

[13] The FDIC's and OCC's regulatory capital rules would use the term "custodial bank" instead of "custodial banking organization". Under the proposal, "custodial bank" would 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.

[14] NPR at 18,178-79.

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

[16] NPR at 18,181.

[17] NPR at 18,181.

[18] NPR at 18,180.

[19] NPR at 18,180-81.

[20] NPR at 18,181.

[21] NPR at 18,181-82.

[22] NPR at 18,182.

[23] NPR at 18,182.

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