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Financial Reform: Custody Banks and the Supplementary Leverage Ratio

What Do Custody Banks Do?

Custody banks engage in the safekeeping and servicing of assets owned by others. Custody banks may also perform services such as the settlement, holding, and reporting of customers' marketable securities and cash. Customers are often asset managers, mutual funds, retirement plans, insurance companies, corporations, endowments, other banks and financial entities, or large private investors. The other unique feature of custody banks is that they often act similarly to escrow in financial transactions, holding onto assets or collateral for the parties to a financial transaction—such as a derivatives trade or a "securities lending" trade—until the trade is finalized and the rightful owner of the asset or collateral collects it. Custody banks do not have a special charter, but are ordinary banks that engage in custody activities.

The custody services industry is highly concentrated. According to one study, as of the end of the first quarter of 2017, the four largest custody banks were Bank of New York Mellon, State Street, J.P. Morgan, and Citigroup, and they held 47% of the total assets under custody in the United States, then totaling $103 trillion.

Although the safekeeping function is not viewed as presenting much underlying credit risk (or risk of loss) to the custody bank itself, the sheer volume of transactions and size of related assets such banks hold highlight the crucial role custody banks play in the functioning of the global financial system. The Office of the Comptroller of the Currency (OCC) sees operational risk as one of the largest risks for custody banks, because the provision of custody services is largely dependent on the successful execution of very large volumes of operational tasks and transactions and requires sophisticated systems. Operational risk is broadly defined as the risk of loss resulting from inadequate or failed internal processes, people, and systems, or from external events, such as cyberattacks.

Figure 1 shows the U.S. banks with the largest custody businesses. Two of the banks, JP Morgan and Citigroup, are diversified conglomerates whose primary line of business is not custody services, and that also engage in investment banking and commercial lending. The other two, Bank of New York Mellon and State Street, according to their annual reports, derive the largest chunk of their revenue from investment servicing fees, including custody fees. Such fee-based revenue often entails lower risk than revenue from trading or lending activities, which carry credit and market volatility risk. Another bank, Northern Trust, though smaller in terms of total assets, also has a large custody business as a share of its total revenue.

Figure 1. Banks with Large Custody Businesses Based on Assets Under Custody (AUC)

AUC ($trillion)	End 2016
Bank of New York Mellon	$29.9
State Street	$28.8
JPMorgan	$20.5
Citigroup	$15.2
Top 4 Total	***$94.4***

Source: The 2016 annual report for each bank.

Custody banks have argued that some of the Basel III requirements implemented after the 2008 financial crisis were inappropriate for their business model, which focuses on the servicing of client assets. Basel III is an internationally agreed-upon set of measures developed by the Basel Committee on Banking Supervision in response to the financial crisis of 2007-2009. In particular, several custody banks have complained about the impact of the supplementary leverage ratio (SLR) under Basel III. They argued that it makes their fee-based, high-volume business disproportionately costly due to reasons discussed below.

What Is the Leverage Ratio and Supplementary Leverage Ratio?

In response to the financial crisis, both the Dodd-Frank Act and Basel III requirements broadly aimed to increase banks' capital holdings to strengthen the financial system's resiliency against future crises. Basel III included risk-based capital requirements to ensure banks hold more capital against riskier assets. It also included a leverage ratio that imposed the same capital charge for every asset, no matter how safe, to provide a backstop and ensure banks hold a minimum amount of capital regardless of their type of assets. The leverage ratio also captures a certain "size footprint" of a bank's total financial activities. Currently, almost all U.S. banks and bank holding companies are subject to a minimum 4% leverage ratio, as measured by the ratio of a firm's high quality or "tier 1" capital, over the sum of all its on-balance sheet assets.

The U.S. Basel III SLR rule also requires large, internationally active U.S. banking organizations (typically, those with $250 billion or more in total consolidated assets or $10 billion or more in on-balance sheet foreign exposures) to meet a minimum 3% SLR. The SLR is measured as the ratio of a firm's tier 1 capital to the sum of all on-balance sheet assets and certain off-balance sheet exposures. The enhanced supplemental leverage ratio (eSLR) standard requires a U.S.-based global systemically important bank holding company (G-SIB) to hold an additional 2% buffer over the minimum SLR requirement for a total of 5% to avoid restrictions on capital distributions and certain discretionary bonus payments. Eight of the largest banks in the United States have been designated as G-SIBs and are subject to such additional prudential requirements. An insured depository institution subsidiary of a U.S. G-SIB is required to meet a 6% minimum SLR to be considered "well capitalized" under the bank regulatory framework.

The principal difference between the leverage ratio and the SLR is that the SLR includes both *on-balance sheet assets* (those that are owned outright and more easily measurable in terms of their potential worth) and *off-balance sheet assets*. Off-balance sheet assets include, for instance, derivatives trades and other assets that could pose a contingent demand for capital and are viewed by some as less transparent risks. An example of off-balance sheet assets includes certain structured investment vehicles (SIVs). In the run-up to the 2008 financial crisis, some banks used SIVs to profit from the difference between short-term borrowing rates and longer-term returns from complex mortgage-backed securities (MBS), while keeping the SIVs off the balance sheet. When the value of those MBS and SIVs fell during the financial crisis, some SIVs incurred losses that were transmitted to the banks. A principal objective of the SLR is to require banking firms to hold a minimum amount of capital against on-balance sheet assets and off-balance sheet exposures, regardless of the measured risk associated with individual exposures.

Custody banks have argued that because the SLR does not account for the riskiness of assets, it may overstate the amount of capital needed to protect against potential losses and unnecessarily tie up capital. This is especially true, they argue, for institutions that disproportionately hold less risky assets, as is the case for custody banks.

What Do Bills in Congress Propose?

A provision in S. 2155 (reported by the Senate Banking Committee on December 18, 2017) would exclude funds (subject to some limitations) of an eligible custodial bank's holding company from that company's SLR calculation when those funds were deposited into accounts at certain central banks. S. 2155 defines *custodial bank* as any depository institution holding company "predominantly engaged in custody, safekeeping and asset servicing activities, including any insured depository subsidiary of such a holding company." A similar bill, H.R. 2121, was agreed to by the House Committee on Financial Services on October 12, 2017, with amendments. The House committee bill defines the SLR more broadly, adding SLR "means the supplementary leverage ratio including applicable buffers, surcharges, and well-capitalized requirements relating to such supplementary leverage ratio."

Both bills would leave it to prudential regulators to further specify which companies are "predominantly engaged" in such activities. The question, for instance, of how broadly regulators interpreted "asset-servicing activities," would potentially impact whether larger, diversified banks, such as Citigroup and J.P. Morgan, with active custodial businesses might be affected. Looking at existing approaches, the current legal definitions of custody activities vary because custody services are used in banking (overseen by a number of prudential regulators); in securities and asset management (overseen by the Securities and Exchange Commission [SEC]); and in derivatives trading (primarily overseen by the Commodity Futures Trading Commission [CFTC] with some SEC oversight). For calculating deposit insurance assessments, the Federal Deposit Insurance Corporation (FDIC) defines a custodial bank as one that had over the previous calendar year at least $50 billion in total fiduciary, custody, and safekeeping assets; or had derived more than 50% of its total revenue from trust activity.

The bills would specify that funds of such a custodial bank deposited into accounts with certain central banks shall not be taken into account when calculating the SLR for the custodial bank. Both House and Senate committee bills specify that accounts qualify only when held at the Federal Reserve System, European Central Bank, and central banks of Organization for Economic Cooperation and Development countries that meet certain creditworthiness standards. In practice, the bills would enable banks meeting the custody bank definition to hold less capital against certain assets viewed as safe—namely, money held in accounts at central banks.

Views of Fed Governors

Lawmakers have been aware of custody banks' concerns for some time. At a July 2017 Senate Banking Committee hearing, Federal Reserve Chair Janet Yellen testified that the Fed is examining adjusting the calibration of the SLR for custody banks in case it is too high relative to risk-based capital requirements. She also noted that one approach other countries had taken is to exempt certain items, such as central bank accounts, from those banks' SLR, and said the Fed is considering reexamining its own approach.

In his farewell speech, former Fed Governor Daniel Tarullo also said it might be worth adjusting the SLR for banks primarily in the custody business. He discussed two approaches—that proposed in S. 2155 and his preferred approach. Tarullo's preferred approach would allow only those large banks with the lowest risk-based capital surcharges (meaning those with less-risky, primarily fee-for-service custodial businesses) to hold less capital through a lower SLR. He argued against the approach (taken in S. 2155) of excluding certain "safe" assets such as central bank reserves from leverage ratio requirements for two reasons. First, he argued that the purpose of a leverage ratio—by contrast to risk-based capital requirements—is to place a cap on total leverage, no matter what the assets may be. Second, he noted, if "safe" assets like central bank reserves were excluded, why not exclude other types of assets viewed as safe, like certain sovereign debt holdings? Doing so could create a "slippery slope" where it becomes difficult to distinguish between other classes of assets.

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