Meeting Between Staff of the Federal Reserve Board and Representatives of Northern Trust Corporation
August 23, 2016

Participants: Sean Campbell, Anna Harrington, Ben McDonough, and Lucy Chang (Federal Reserve Board Staff)

Paul Sassieni, Tamela Merriweather, Kelly Dibble, Jennifer Durkin, and Ryan Hayden (Northern Trust Corporation)

Summary: Staff of the Federal Reserve Board met with representatives of Northern Trust Corporation to discuss the proposed rule for single counterparty credit limits ("SCCL") that the Board issued for public comment pursuant to section 165(e) of the Dodd-Frank Wall Street Reform and Consumer Protection Act as part of the Board's Regulation YY (Docket No. R-1534, RIN 7100–AE 48).

Among the issues raised by the representatives of Northern Trust Corporation regarding the proposed rule were:

- The nature of client-driven demand deposits;
- Impact of a breach of SCCL due to the traditional activities of custodian banks;
- Possible exemption for custodial activities to exclude credit exposures to a counterparty in connection with payment or settlement activities in the ordinary course of business, subject to certain conditions;
- Revision to expressly permit exercise of the Board's exemptive authority to tailor application of SCCL to short-dated exposures of specific companies; and
- Possible inclusion of a "cure period" for exceeding SCCL due to traditional activities of custodian banks.

Materials discussed in the meeting are attached.

Impact of Single-Counterparty Credit Limits on Traditional Activities of Custodian Banks

Prepared by The Northern Trust Company, August 23, 2016

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OVERVIEW

- The traditional global custody bank model facilitates the efficient and timely global settlement of securities and foreign exchange transactions, receipt of investment-related income, subscriptions, redemptions, routine payment services and other common market transactions.
- Affording custody banks relief that does not unduly constrain short-term counterparty exposures will support ongoing provision of market liquidity and prompt reinvestment by the large institutional investors who are clients of global custody banks, such as pension funds, mutual funds, and other large institutional investors.
- The Final SCCL Rule should therefore be modified to:
  – Exempt short-term exposures arising from traditional global custody services
  – Allow the exercise of exemptive authority to tailor application of SCCL to short-dated exposures of specific companies

RELEVANT PRECEDENT FOR EXEMPTION

Global and domestic regulation recognizes short-term obligations as presenting less risk:

- Regulation Q does not require risk-based capital for securities and foreign exchange transactions in the event the covered institution's counterparty provides delivery within five business days post-settlement
- The "Advanced Approaches" capital rules methodology does not apply to custody-related short-term obligations
- The exemptive provision under Regulation Q, adopts a "principle of conservatism" for a covered institution to effectively carve-out certain exposures at the Fed's discretion
- EU Regulation No. 575/2013 exempts certain transactions involving the purchase or sale of securities within a short-dated timeframe
- EU Regulation No. 575/2013 recognizes that certain client-driven exposures resulting from custody and other related services should be exempt to "facilitate the smooth functioning of financial markets…"
- Interbank Short-term obligations (including bank deposits) are exempted from the Legal Lending Limits applicable to some State-Chartered custodian banks

ROLE OF CUSTODIAN BANKS IN THE MARKETS

- Global custodians are widely recognized as integral to the smooth functioning of financial markets, and maintaining a centralized global custody relationship facilitates by institutional investors with regulations governing their use of custody services. (For more information on traditional custody services, please refer to *The Custody Services of Banks,* The Clearing House, July 2016.)
- In the normal course of providing these services, global custodians receive and make payments in a variety of currencies based on their clients' market activity, which can result in large cash deposits with a network of local sub-custodian banks.

NATURE OF CLIENT-DRIVEN DEMAND DEPOSITS

Taken independently or together with other SCCL exposures, client-driven demand deposits could inadvertently cause a global custodian to exceed its SCCL limits.

- A client may sell securities resulting automatically in a cash deposit with its global custodian. Effectively that client deposit becomes a deposit held in the name of the global custodian with the sub-custodian which might remain overnight or for several days for the following reasons:
  - Cash proceeds may be received late in the day and too late for reinvestment activity.
  - Settlement fails on securities purchases may result in unexpected cash balances remaining in an account.
  - A client may have sold securities but not yet decided on reinvestment activity or repatriation of assets from a market. Clients may not advise the Global Custodians of their intentions and therefore the cash needs to remain available in the account with the sub-custodian for immediate withdrawal or investment.
- Clients such as pension funds or endowments may make scheduled disbursements and in anticipation sell securities over a period of time to generate liquidity. These cash balances remain in the account with the global custodian (and therefore the sub custodian) until the periodic disbursement is made.

IMPACT ON TRADITIONAL ACTIVITIES OF CUSTODIANS

- **Scenario: SCCL Breach Due to Traditional Activities of Custodian Banks**
  - Multinational PF is pension fund with accounts are custodied at GC, a US global custodian bank with a global network of sub-custodians.
  - Multinational PF owns 100 shares of AUS Shipping Co. which are sold for AUD800 million during the Australian trading day.
  - Proceeds from the sale are automatically deposited in Multinational PF's GC local sub-custody account at APAC Bank, but cannot be reinvested prior to the end of the trading day leaving it in the account overnight or for several days. GC has not received any communication from Multinational PF regarding the intended use of proceeds or the timing of any reinvestment.
  - When Multinational PF's sub-custody account balance is aggregated with GC's other exposures to APAC Bank, GC exceeds its SCCL exposure to APAC Bank.
  - Three days later, Multinational PF reinvests the sale proceeds in other securities.
- These occasional increases in demand deposits can result in significant short term spikes in account holders' sub-custodian balances. (See Appendix A)
- Such spikes can be expected to occur with greater frequency if short-term demand deposits are aggregated with limits on exposures generated from securities lending and other SFTs.

EXEMPTION FOR TRADITIONAL CUSTODY SERVICES

In order to mitigate the unintended constraints on custody-related services and the short-dated exposures arising from the provision of such services, the Proposed Rule should be revised to include the following:

- **Custodial activities exemption**
  - Include an exception that would exclude credit exposures to a counterparty in connection with payment or settlement activities in the ordinary course of business, subject to certain controls that may include the following:
    - (i) The exposure arises in the normal course of providing payment or settlement services for investment-related transactions, including foreign exchange, securities, derivatives, commodities and similar transactions;
    - (ii) The covered company has policies and procedures that appropriately govern the credit and liquidity risks of the counterparty, exposures related to payments and settlements, and that monitor exposures daily;
    - (iii) To the extent that the aggregate exposure to the counterparty exceeds the SCCL, the covered company takes appropriate action, consistent with safety and soundness considerations, to reduce the excess exposure as quickly as reasonably practicable and in any event within ten business days of the day the excess first occurred; and
    - (iv) The covered company reports the excess exposure to its primary Federal regulator not later than the first business day after the excess occurs.

EXEMPTION FOR TRADITIONAL CUSTODY SERVICES

In order to mitigate the unintended constraints on custody-related services and the short-dated exposures arising from the provision of such services, the Proposed Rule should be revised to include the following:

- **General exemptive authority/supervisory monitoring**
  - Include regulatory exemptive authority to provide explicit flexibility for tailoring the rule for a particular covered company based on the company's risk profile
- **Alternatively, the Proposed Rule could also include a "cure period" for exceeding SCCL limits due to traditional activities of custodian banks, however, this may not provide sufficient relief**
  - Industry groups have advocated for an "enhanced cure period" to allow swift remediation of and reporting related to breaches of SCCL caused, at least in part by spikes in short-term demand deposits
  - Although we support such a cure period as an acceptable alternative if either of the two other preferred options were unavailable, it should be noted that such a cure period would (i) be duplicative of the information contained in the weekly exposure reports prepared for each bank's supervisory staff at the Fed and (ii) not remedy or constrain the potential for such a breach as any such breach is normally short-term in nature and should be resolved promptly

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