STANFORD BUSINESS GRADUATE SCHOOL OF | Corporations and Society Initiative

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Legislative and Regulatory Activities Division
Office of the Comptroller of the Currency
400 7th Street, S.W.
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Washington, D.C. 20219
Docket ID OCC– 2019–0001

Robert E. Feldman
Executive Secretary
Attn: Comments
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, D.C. 20429
RIN 3064–AE81

Ann E. Misback
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, D.C. 20551
Docket No. R–1659; RIN 7100–AF 46

Re: 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

Ladies and Gentlemen:

Thank you for the opportunity to comment on your agencies' proposal to amend the regulations constraining the amount of leverage employed by the largest financial institutions, namely large custody banks. As you know, your agencies considered custody bank arguments when crafting the original leverage ratio and enhanced leverage ratio rules, and arrived at a reasonable solution that balanced the burdens on custody operations during a crisis "flight to safety" against the risks from potential "hot money" outflows.[1] I am troubled by the impact of the proposed rule, should it be implemented, for the reasons described below.

Should you choose to move forward, I urge your agencies to take additional steps to mitigate the risks that your agencies are creating in this proposal. While the underlying statutory provision may require the specific change provided for in the proposed rule, your agencies have other tools at their disposal, including broad safety and soundness and systemic risk authorities, to

[1] *See* 79 Fed. Reg. 24,528, 24,535 (May 1, 2014). We will never know, but it is also worth contemplating what private sector innovations might have addressed this issue. In other contexts, for example, institutions have moved to fee-based services and/or passed along the interest income from the investment of cash to their customers in order to alter the accounting treatment of certain assets.

mitigate the risks posed by the global, systemically important custody bank business model. I will discuss these in more detail below.

I. The provision of law which authorizes the proposal is based upon a flawed premise.

It bears saying at the outset: there is no such thing as a completely riskless asset or line of business.[2] Excluding an asset from the denominator of the leverage ratio repeats the flawed reasoning of the risk weighting system, namely that it relies upon models that are subject to the frailties of human design, including subjective assumptions and a false sense of predictability.[3] A leverage ratio, particularly if it is appropriately high, recognizes the inherent uncertainty in risk modeling and its associated projections. Incorporating subjective, politically motivated determinations about which assets are safe or not is a step toward making the leverage ratio more like the risk-based capital system.[4] This is only the beginning of a slide down the slippery slope.[5]

II. Custody banks present significant risks in general.

Custody banks offer a variety of services that make them akin to large asset managers, and which played a role during the financial crisis:

- They sponsored money market mutual funds. Money market funds experienced significant fragility during the financial crisis, exemplified by the fact that BNY Mellon was required to support its funds, resulting in losses.[6]

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[2] Even assets that are safe from a credit risk perspective can display other risk attributes, for example, liquidity risks and foreign exchange risks. In addition, an institution can have operational risks associated that affect all of its assets.

[3] *See* Paul Pfleiderer, "Chameleons: The Misuse of Theoretical Models in Finance and Economics," available at https://www.gsb.stanford.edu/sites/gsb/files/3020.pdf.

[4] Some will surely argue that the proposed change is innocuous because custody banks are subject to a suite of other supervisory and prudential measures, for example, more stringent stress testing scenarios. However, it is important to note that the counterparty default scenario layered on top of the other stress tests omits certain sovereign entities, meaning that any default of such an entity would have knock-on effects across several different regulatory measures, impacting the balance sheet in unpredictable ways. *See* Board of Governors of the Federal Reserve System, 2019 Supervisory Scenarios for Annual Stress Tests Required under the Dodd-Frank Act Stress Testing Rules and the Capital Plan Rule, at 7, n.10 (Feb. 2019) (noting that sovereign entities, including Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States are excluded from consideration as a bank holding company's largest counterparty under the counterparty default scenario).

[5] *See* Editorial, *Big Bank Custody Fight*, Wall St. J., Mar. 7, 2018 ("If central bank deposits are exempted from the leverage ratio, why not Treasurys or municipal debt?"). An additionally troubling aspect of the exclusion of central bank deposits is the required calculation of the deposits that are "linked" to fiduciary and custody accounts. This introduces added complexity that will increase the risks from these institutions. Understanding that the FDIC already has such a concept from the purposes of deposit insurance assessments, the concept underlying that rule is distinguishable in significant ways from the concepts of asset-liability matching, leverage calculation, and so on.

[6] *See* Fin. Crisis Inquiry Comm'n, *The Financial Crisis Inquiry Report* 357 (1st ed. 2010) ("BNY Mellon announced support for various funds that held Lehman paper, including the $22 billion Institutional Cash Reserves fund and

- They sponsored asset-backed commercial paper (ABCP) conduits. State Street's ABCP conduits deteriorated during the crisis, leading to a 60% drop in the bank's stock price and a need to transfer the conduits back onto its balance sheet.[7]
- They provide overdrafts to their clients. State Street's decision to freeze the money market fund Reserve Primary's overdraft line was an important factor in that fund's stress.[8]
- They serve as clearing banks. During the financial crisis, the clearing banks in the repo market clamped down and made collateral calls, exacerbating funding issues at other financial institutions.[9]

Their role in clearing repo transactions is important. The fear that clearing banks, including BNY Mellon, would force lenders to unwind their trades led the Federal Reserve to consider creating a facility to keep the triparty market functioning.[10] Although there have been some reforms to the repo markets post-crisis, the Financial Stability Oversight Council (FSOC) has noted that there has been an increase to financial stability risks because "just one institution became effectively responsible for all clearing of that important market segment."[11] According to FSOC, "[e]ven a temporary service disruption, such as an operational failure, could impair the market, as participants may not have a ready alternative platform to clear and settle these transactions."[12] While the FSOC does not identify the institution of which it is speaking, it is BNY Mellon.[13]

It is likely that the Federal Reserve System would again be called upon to prop up the repo market in some capacity, including BNY Mellon, should the market experience stress.[14] Robust

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four of its trademark Dreyfus funds. BNY Mellon would take an after-tax charge of $425 million because of this decision."). While their TARP borrowing was smaller than the other GSIBs, the custody banks did receive significant support from other crisis support programs. *See* Statement by Martin J. Gruenberg, Member, Board of Directors, FDIC, "Revisions to the Supplementary Leverage Ratio Capital Rule for Custody Banks," Mar. 29, 2019 (observing that "State Street and Bank of New York Mellon between them utilized more than $80 billion of public support from the FDIC's Temporary Liquidity Guarantee Program.").

[7] Raj Date, *Test Case on the Charles: State Street and the Volcker Rule* 7-9, Cambridge Winter Center on Financial Institution Policy, June 12, 2010. However, State Street "did not face a liquidity run, however, in major part because of pre-existing funding backstops provided by the Fed's Commercial Paper Funding Facility (CPFF) and the FDIC's Term Liquidity Guarantee Program (TLGP), coupled with taxpayer-supplied capital through the TARP and a post-'stress test' private market equity raise." *Id.*, at 9.

[8] *See* FCIC, *supra*, at 356 ("With no means to borrow, Primary Fund representatives reportedly described State Street's action as 'the kiss of death' for the Primary Fund.").

[9] *See id.*, at 355; *see also id.*, at 361.

[10] *See id.*, at 295-96.

[11] Fin. Stability Oversight Council, 2018 Annual Report 110 (revised June 20, 2019), available at: https://home.treasury.gov/system/files/261/FSOC2018AnnualReport.pdf.

[12] *Id.*

[13] *See, e.g.*, Katy Burne, *New Worry in 'Repo': Just One Bank for $3.5 Trillion Market*, Wall St. J., Aug. 30, 2017.

[14] *See* Ofc. of Fin. Research, *Size Alone is Not Sufficient to Identify Systemically Important Banks* 8, OFR Viewpoint 17-04 (Oct. 2017)("In 1985, Bank of New York Mellon, then known as the Bank of New York, received a $23 billion discount-window loan from the Federal Reserve after an operational failure left the firm unable to redeliver securities it had received as an intermediary from other institutions."(citations omitted)).

funding will keep this utility function flowing smoothly, avoiding the need for bailouts. A strong leverage ratio is a necessary safeguard against such unforeseen and unexpected problems, because this type of systemic importance – the concentration of critical functions – is not accurately reflected in the calculation of other prudential regulations such as the GSIB score for risk-based capital.[15]

III. The custody business specifically presents some unique risks that are difficult to assess.

The custody business has been described as a "dreadfully dull affair," but one that is "scale intensive [and] IT-dependent."[16] Though custody activities "might not pose major credit risk they do carry significant operational and other risks[.]"[17] One example of such a risk is the time, in 2015, when a glitch at BNY Mellon's mutual fund software platform caused a "weeklong crisis in one of the most basic but crucial sections of Wall Street's infrastructure," that "cascaded across Wall Street."[18] Another is when BNY Mellon lost the ability to process payments using the Swift platform for 19 hours in 2016.[19] Or, as mentioned above, the operational failure in 1985 – when BNY Mellon was significantly smaller – that led to a $23 billion discount window loan.

These specific risks involve information technology platforms and other technological infrastructure. FSOC has noted that a cybersecurity event could have implications for financial stability: interdependent platforms can cause cascading effects; fire sales can result from a loss of market confidence; and data integrity could be compromised.[20] These risks are idiosyncratic in nature because they are difficult to predict, to quantify, and to solve for in the manner that financial risks are typically modeled. In addition, the risks are amplified when concentrated in institutions that combined hold nearly $52 trillion in assets under custody, if a significant portion needs to be moved quickly.

These are just the operational risks presented by custody banks' payment functions. Like all banks, custody banks present other types of operational risks as well. For example, BNY Mellon settled allegations of overcharging customers for foreign exchange services for $714 million.[21] It was also subject to a $6 million penalty for pledging ineligible collateral to the money market fund bailout facility as a result of a failure of internal communication and escalation practices.[22] In 2017, BNY Mellon was fined $3 million for improperly assigning zero risk weighting to certain

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[15] *See* OFR, *Size Alone is Not Sufficient to Identify Systemically Important Banks*, *supra*.
[16] Date, *Test Case on the Charles*, *supra*, at 5.
[17] Statement by Thomas M. Hoenig, Vice Chairman, FDIC, "Senate Banking Committee Passage of S. 2155, the Economic Growth, Regulatory Relief and Consumer Protection Act," Dec. 5, 2017.
[18] Kirsten Grind, *All-Night Push After Glitch Hit BNY Mellon*, Wall St. J., Sept. 3, 2015.
[19] *See* Katy Burne, *Bank of New York Lost Ability to Process Payments for 19 Hours*, Wall St. J., Dec. 7, 2016.
[20] *See* FSOC, Annual Report, *supra*, at 107.
[21] *See* Tom Braithwaite & Gina Chon, *BNY* Mellon to pay $700m over fraud claims, Fin. Times, Mar. 19, 2015.
[22] *See In the Matter of The Bank of New York Mellon*, Docket No. 12-018-CMP-SMB (Apr. 13, 2012) available at: https://www.federalreserve.gov/newsevents/pressreleases/files/enf20120416a1.pdf.

variable interest entities that it had consolidated onto its balance sheet (into its trading book), and thereby understating its risk-weighted assets and overstating its capital ratio for 14 quarters.[23]

At the same time, over the past five years, State Street has paid out at least $723 million in fines, settlements, and other payments related to overcharging its customers for a variety of fees, the largest component consisting of foreign exchange fees.[24] It was also subject to a 2015 joint state and federal Bank Secrecy Act/Anti-Money Laundering enforcement action.[25]

The potential costs arising from these risks are substantial. The "financial services and products provided by these global custody banks are an essential part of the financial markets' infrastructure, and are not easily substituted by other market participants should these firms be subject to material financial distress."[26] The ability to continue providing vital services to clients depends on a robust funding structure, including ample equity to avoid runs and other pressure.

IV. The agencies have the authority to offset the risks posed by custody banks by other means.

An unweighted leverage ratio based upon pure common equity is the best way to protect against unforeseen financial risks. Unfortunately, this proposal will reduce the GSIB custody banks'

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[23] *See In the Matter of The Bank of New York Mellon*, Docket No. 17-016-CMP-HC (June 26, 2017) available at: https://www.federalreserve.gov/newsevents/pressreleases/files/enf20170627a1.pdf.

[24] *See* Robert Armstrong, *State Street Settles Claims It Overcharged Clients — Again*, Fin. Times, June 27, 2019.

[25] *See Written Agreement between State Street Corp., State Street Bank & Trust Co., the Fed. Reserve Bank of Boston & Mass. Division of Banks*, Docket Nos. 15-015-WA/RB-HC & 15-015-WA/RB-SM (May 15, 2015), available at: https://www.federalreserve.gov/newsevents/pressreleases/files/enf20150601a1.pdf

[26] Gruenberg, "Revisions to the Supplementary Leverage Ratio Capital Rule for Custody Banks," *supra*. While this letter largely focuses on the two largest, global systemically important custody banks, it should be noted that the third, "smaller" custody bank has also experienced compliance and operational challenges. Northern Trust reached combined settlements worth $60 million in multiple investor lawsuits for breaching its fiduciary duty under ERISA for imprudently managing its securities lending program and charging unreasonable fees. *See* Becky Yerack, *Northern Trust to Pay $60 Million to Settle Securities-lending Cases*, Chicago Tribune, Feb. 23, 2015. It was fined $600,000 by FINRA for inadequate oversight of its collateralized mortgage obligation sales and high-volume securities trades, leading to 43.5% of trades going unmonitored for an 18-month period. *See* Press Release, "FINRA Fines Northern Trust Securities, Inc. $600,000 for Inadequate Supervision of Sales of Collateralized Mortgage Obligations and Certain High-Volume Securities Trades," FINRA, June 2, 2011, available at: https://www.finra.org/newsroom/2011/finra-fines-northern-trust-securities-inc-600000-inadequate-supervision-sales. It was also fined $60,000 by the SEC for making misrepresentations related to its municipal bond underwriting. *See In the Matter of The Northern Trust Company*, File No. 3-16628 (June 18, 2015) available at: https://www.sec.gov/litigation/admin/2015/33-9835.pdf. Finally, its 2017 resolution plan filing was found to contain three shortcomings that would impede its resolvabilty, and its most recent filing still falls short in demonstrating that it can safely be resolved in bankruptcy, without a taxpayer bailout. *See* Board of Governors of the Federal Reserve System & Federal Deposit Insurance Corporation, Letter to Northern Trust Corporation Concerning Title I Resolution Plan Submission, Mar. 24, 2017; *see also* Statement by Martin J. Gruenberg, Member, Board of Directors, FDIC, "Letter to Northern Trust Corporation Concerning Title I Resolution Plan Submission," Mar. 29, 2019 (stating that Northern Trust's resolution plan is based on a series of unrealistic assumptions).

leverage capital requirements by an estimated $7 billion – an astounding 23% reduction from their current leverage requirement – thereby increasing their fragility.[27]

While the legislation may require this specific revision to these existing regulations, it does not *prevent* your agencies from using your authority under other provisions of law to counteract the increased threats to safety and soundness and financial stability resulting from this change, by, for example:

1. Using either safety and soundness authority or financial stability authority to impose a new leverage ratio that deals specifically with the risks posed by the banks that are deregulated by this rule;[28]
2. Re-calibrating the method 1 GSIB surcharge, by removing the cap on the substitutability factor that was a special dispensation to the GSIB custody banks,[29] in order to significantly increase the GSIB risk-based capital surcharges for the largest custody banks; or
3. Making the Basel 3 capital rules, as implemented by your agencies, more robust in their approach to operational risk, to better reflect the nature of the risks posed by significant custody activities.[30]

The conversation around financial regulation often centers the concept of "tailoring": that an institution's regulation should reflect its "risk profile." The result of this argument, however, has generally been reduced regulations for banks. Through any of the above proposals, your agencies could apply more robust regulations that befit the business model of custody banks.

Thank you for considering my views on this important matter.

Sincerely,

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[27] *See* 83 Fed. Reg. 18,175, 18,182 (Apr. 30, 2019).
[28] *See* 12 U.S.C. §§ 1818, 1844, 5365.
[29] *See* 157 Fed. Reg. 49,082, 49,096 (Aug. 14, 2015).
[30] *See*, *e.g.*, Peter Sands, Gordon Liao & Yueran Ma, *Rethinking Operational Risk Capital Requirements*, Working Paper No. 2016-06 (2016) (discussing existing and alternative approaches to operational risk capital requirements).