April 14, 2017

The Honorable Mike Crapo
Chairman, Senate Committee on Banking, Housing, and Urban Affairs
534 Dirksen Senate Office Building
Washington, DC 20510-6075

The Honorable Sherrod Brown
Ranking Member, Senate Committee on Banking, Housing, and Urban Affairs
534 Dirksen Senate Office Building
Washington, DC 20510-6075

Dear Chairman Crapo, Ranking Member Brown and Members of the Committee:

The Bank of New York Mellon Corporation, Northern Trust Corporation, and State Street Corporation, (collectively, the custody banks) respectfully submit two proposals that we believe would facilitate investment to grow the economy, accumulate wealth for investors, and provide a safe haven for investors during market uncertainty or stress.

We believe that the following simple, targeted modifications would mitigate regulatory impediments to the ability of the custody banks to provide investment services and accept customer deposits:

(1) Exclude central bank placements from the "total leverage exposure" of the Supplementary Leverage Ratio; and
(2) Reinstate the Accumulated Other Comprehensive Income (AOCI) filter in regulatory capital.

We look forward to working with the Senate Banking Committee staff and members to develop these two proposals into bipartisan legislative language.

<u>Background</u>:

Investors depend on the custody banks for day-to-day services to facilitate their investments. Pension funds, state treasurers, corporations, investment funds, endowments, and other institutional investors engage custody banks to facilitate their investments in the United States and around the globe. A fund may hire a custody bank, for example, to pay and receive dividend and debt interest payments, process asset sales and purchases, and most importantly, hold and safekeep assets. The customer pays the custody bank a fee for these investment services. Fees for these services, rather than revenue from credit risk assets, constitute the large majority of the custody banks' revenue.

These services are necessary to ensure the seamless flow of investments and payments that most Americans take for granted. Readily available cash deposits are needed to facilitate these services. Customers must be able to deposit cash in their accounts to meet normal course

payment obligations, such as purchases of assets. Customers also predictably deposit additional cash at the end of each month or quarter, for example, as they prepare to make quarterly dividend payments or monthly pension payments. Separate from these normal course deposit flows, customers also may deposit "surge" amounts during times of stress as they exit the markets and increase cash holdings in the "flight to cash."

On the asset side, the custody banks place these customer deposits at central banks, in U.S. Treasuries, or in other highly liquid securities to facilitate payments and manage liquidity. In times of stress, a customer might need the cash the next day (to meet higher than usual investor withdrawals, for example), or a customer might not need the cash for several months as it waits to invest once the market has settled.

Unfortunately, these "back-office" functions often are overlooked in the capital and liquidity rule-writing process. The "one-size-fits-all" regulations designed to target consumer banking or investment banking can cause idiosyncratic, negative effects when applied to custody banking.

This is not simply a matter of increased incremental cost. New regulations are driving fundamental business decisions, including whether we take on a new customer, provide a new service, or even accept a new deposit. Worse, these idiosyncratic regulatory effects on the custody banks are not balanced by financial stability benefits. They may, in fact, reduce our ability to manage risk and to provide a safe haven during times of market uncertainty and stress.

Two additional factors compound these problems. Custody banking is largely an American business, led by the three custody banks: The Bank of New York Mellon Corporation (headquartered in New York, NY), State Street Corporation (headquartered in Boston, MA), and Northern Trust Corporation (headquartered in Chicago, IL). Foreign regulators have little understanding, or consideration, of the custody bank business model when setting international standards. Second, in implementing these international standards, the United States prudential regulators historically have required even more capital than the original international standards.

The custody banks offer two proposals that would mitigate regulatory impediments to our ability to provide investment services and accept deposits.

I. Exclude Central Bank Placements from the Supplementary Leverage Ratio (SLR)

Brief description of the proposal:

Following the financial crisis, the Basel Committee on Banking Supervision (BCBS) introduced a new, 3 percent Basel III leverage ratio of tier 1 capital in the numerator to on- and off-balance sheet assets in the denominator. The U.S. banking agencies adopted the Basel III leverage ratio as a Supplementary Leverage Ratio (SLR) requirement for all advanced approaches banking organizations.

In 2014, the U.S. banking agencies then added an "enhanced" SLR for U.S. global systemically important banking organizations (GSIBs)—over and above the Basel III requirement. The enhanced SLR effectively requires 5 percent tier 1 capital at the GSIB holding company and 6 percent at the GSIB insured depository institutions.

In the final rule, the U.S. banking agencies described the enhanced SLR as "particularly relevant for large, complex organizations that are internationally active and often have substantial off-balance sheet exposures."[1] As such, the U.S. banking agencies stated that banks could meet the enhanced SLR "without much economic cost" by "reducing the net notional amount of sold credit protection by matching maturity more closely with purchased credit protection" and by "further compressing their over-the-counter derivative trades."[2]

Yet, the U.S. banking agencies chose to apply the enhanced SLR without regard to each GSIB's underlying business model or risk profile. The SLR does not contain provisions for business model tailoring and requires the same amount of leverage capital for all assets. Custody banks do not pose the risks that the SLR is intended to address, and as a result, the SLR is disproportionately costly for custody banks. These banks have few trading activities, and as a result cannot take steps to better hedge credit protection or compress trades. Instead, the custody bank business model focuses on the servicing of client assets, and it is client deposits that drive the custody bank balance sheet. Custody banks place these deposits at central banks and in other highly liquid assets to facilitate client transactions and to provide clients with a safe haven during times of stress.

To manage these realities, custody banks have reduced client deposits and modified investment portfolios. Custody banks have made these changes to comply with regulations—and not because they would better serve clients or grow the economy.

These actions could be even more drastic during times of market uncertainty or stress. Custody banks may be forced to turn away client deposits, for example, because they would not be able to absorb the significant balance sheet increase without breaching the SLR. This could significantly exacerbate market stress and decrease financial stability.

To mitigate these effects, the SLR should be tailored to exclude central bank placements.

Impact on economic growth and on the ability of consumers, market participants, and financial companies to participate in the economy:

The inclusion of central bank placements in the SLR limits the ability of the custody banks to provide day-to-day services to investors. This limits the efficiency and effectiveness of the U.S. and global financial system. The SLR also limits the ability of the custody banks to provide a safe haven for investor assets during times of market uncertainty or stress.

Legislative language:

We look forward to working with Committee staff on legislative language that would be narrow and focused on relief for the custody banks.

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[1] Regulatory Capital Rules: Regulatory Capital, Enhanced Supplementary Leverage Ratio Standards for Certain Bank Holding Companies and Their Subsidiary Insured Depository Institutions, 79 Fed. Reg. 24528, 24530 (May 1, 2014).

[2] Memorandum from Staff to the Board of Governors re: Final Rule on Enhanced Supplementary Leverage Ratio (SLR) Standards, 11 (April 4, 2014).

II. Reinstate the Accumulated Other Comprehensive Income (AOCI) Filter

Brief description of the proposal:

In 2010, the BCBS removed the AOCI filter that was long part of regulatory capital calculations. Removal of the AOCI filter means that *unrealized* accounting "gains" or "losses" on available for sale (AFS) securities, such as U.S. Treasuries, are reflected in common equity tier 1 (CET1) capital. The U.S. banking agencies adopted this change in 2013 for "advanced approaches" banking organizations.

Removal of the AOCI filter causes a number of distortions to a bank's capital that mask a bank's true capital position and that tie up capital otherwise available for lending and investments.

First, removal of the AOCI filter creates artificial volatility in capital levels. Much of the AFS portfolio is in fixed-rate debt securities. A decrease in interest rates increases the value of debt securities, and an increase in interest rates decreases the value of debt securities. Fluctuations in interest rates cause fluctuations in the value of AFS securities, and hence fluctuations in the amount of regulatory capital. These capital fluctuations are due to changes in interest rates and not due to changes in credit or other risks. A change in interest rates is something that simultaneously affects all banks, yet no bank can readily control.

Second, removal of the AOCI filter creates an inaccurate picture of actual capital levels. Without the AOCI filter, unrealized gains on unsold AFS securities artificially inflate the amount of capital a bank is perceived to have, and unrealized losses artificially depress capital. This may create a false impression of the actual capital available to a bank to support lending and investments.

Third, removal of the AOCI filter creates an inaccurate and incomplete view of the interest rate exposure of a bank. The AOCI filter applies only to AFS securities. But a bank's net interest rate exposure also depends on other assets and on fixed-rate liabilities, such as deposits. In fact, banks often hold high quality, fixed-rate debt securities (*e.g.*, U.S. Treasuries) to hedge against the interest rate risk of fixed-rate liabilities. Banks should not be penalized for this well-established, sound, risk management practice.

Fourth, the SLR and the Liquidity Coverage Ratio (LCR) requirements have made these issues even more pronounced. The LCR requires banks to hold a large pool of highly liquid, low-risk, low-yielding assets. The SLR is risk insensitive and increases the relative capital cost of these very same highly liquid, low-risk, low-yielding assets. To manage these competing regulatory standards, it would be most sensible to hold highly liquid assets (to satisfy the LCR) that earn an adequate return (to satisfy the capital cost of the SLR). But the types of assets that satisfy these criteria—longer duration debt securities, such as U.S. Treasuries—are precisely the types of securities that are most sensitive to interest rate fluctuations that cause capital volatility.

Thus, in a perverse cycle, highly liquid assets increase capital volatility, further increasing the need for a capital "cushion" over and above the regulatory capital minimums. This is capital that otherwise could be deployed for lending and investments. This issue is particularly acute for the

custody banks because our servicing business model requires the maintenance of a large portfolio of U.S. Treasuries, Agency securities, and other high quality, liquid assets.

Recognizing the shortcomings of the Basel III approach, the U.S. banking agencies provided non-advanced approaches banking organizations an opportunity to retain the AOCI filter. The custody banks should be provided the same opportunity.

Impact on economic growth and on the ability of consumers, market participants, and financial companies to participate in the economy:

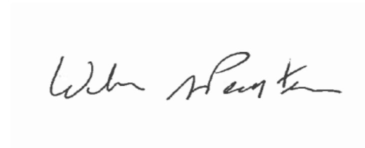
Reinstating the AOCI filter would reduce volatility and better reflect actual capital levels. This would allow the custody banks to better manage their capital and interest rate risk, freeing up capital that could be deployed for lending and investments.

Reinstating the AOCI filter also would remove the undue capital penalty on longer duration debt securities, such as U.S. government and agency debt obligations, mortgage backed securities, and municipal debt instruments. This would, among other things, open up the market for 30-year mortgages and decrease borrowing costs for municipalities.

Legislative language:

We look forward to working with Committee staff on legislative language that would be narrow and focused on relief for the custody banks.

Respectfully submitted,



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About BNY Mellon:
BNY Mellon is a global investments company dedicated to helping its clients manage and service their financial assets throughout the investment lifecycle. Whether providing financial services for institutions, corporations or individual investors, BNY Mellon delivers informed investment management and investment services in 35 countries and more than 100 markets. As of December 31, 2016, BNY Mellon had $29.9 trillion in assets under custody and/or administration, and $1.6 trillion in assets under management. BNY Mellon can act as a single point of contact for clients looking to create, trade, hold, manage, service, distribute or restructure investments

About State Street:
Headquartered in Boston, Massachusetts, State Street specializes in the provision of financial services to institutional investor clients. This includes investment servicing, investment management, data and analytics, and investment research and trading. With $28.77 trillion in assets under custody and administration and $2.47 trillion in assets under management as of December 31, 2016, State Street operates in 30 countries and in more than 100 geographic markets.

About Northern Trust:
Northern Trust is a leading provider of wealth management, asset servicing, asset management and banking services to corporations, institutions, affluent families and individuals around the world. As of December 31, 2016, Northern Trust has more than 20 international locations, assets under custody of $6.7 trillion, and assets under management of $942 billion.