Federal Financial Analytics, Inc.

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Federal Financial Analytics Finds Well-Intentioned Policy May Have Unintended Consequences

New Study Examines US Custody-Bank Capacity to Take Cash Deposits

WASHINGTON, DC, August 4, 2015 - Federal Financial Analytics, Inc. (FedFin) today released a study finding that U.S. custody banks could provide an additional safety net of at least $182 billion for the global financial system if excess reserves held at central banks were not subject to heightened leverage-capital requirements.

"Tougher rules to prevent the next crisis are an urgent priority," said FedFin managing partner Karen Shaw Petrou. "But, tough rules that make the financial system weaker are an unfortunate result of well-intentioned policy. As a result, the financial system is less stable, and U.S. custody banks cannot serve a critical market need: a safe store of value immediately available upon demand under even acute market stress," she continued. Custody banks take deposits from investment companies, pension funds, endowments, sovereign wealth funds, and other large investors, providing them with a secure depository for cash needed to ensure their liquidity and safeguard their resilience.

Custody banks now house much of the excess cash deposits received from institutional investors at the Federal Reserve in the form of "excess reserves," assets held at the FRB that pose no risk to the bank. Current rules nonetheless treat these excess reserves in the same manner as trading assets, subprime mortgages, or other assets on a bank's books and thus subject them to the same capital requirements. Custody banks cannot speculate with excess reserves or otherwise make use of them, one reason institutional investors rely on custody banks as their cash depositories.

Key points in the new FedFin study include:

- The cumulative impact of geopolitical risk, market volatility, monetary policy, and new regulations has created a strong, secular influx of large cash deposits at U.S. custody banks resulting in a 34% increase since 2011.

- There is thus a clear pattern of growing cash-liability demand, with investment funds now holding sustained volumes of cash and cash-equivalents 205% greater than those held at the depth of the crisis.

- Pricing flexibility is unlikely to offset regulatory costs due to U.S. price inelasticity, statutory deposit drivers, and other market factors in the current interest rate environment.

- Current market conditions are particularly volatile and illiquid, posing systemic risk. Suggestions that regulations may be waived to permit custody banks to absorb sudden deposit inflows cannot be counted upon in advance by banks or customers. Sudden unavailability of cash-deposit facilities poses operational and even systemic risk because investment companies and other entities could face a choice between violating applicable law or suddenly ceasing critical operations in the absence of cash depositories.

- Alternative deposit options pose more risk than higher custody deposit capacity because funds will likely flow outside the U.S., outside the banking system into "shadow liabilities," or into attempts to hold larger amounts of high-quality assets at a time when market shortfalls are creating significant volatility. Structural and regulatory factors suggest these shortfalls will not quickly reverse.

- Central-bank facilities to counter liquidity transfers outside custody or other banks may force creation of market-maker-of-last-resort facilities. Absent regulation that offsets arbitrage and moral hazard, additional risk not only to the financial system, but also to taxpayers may ensue.

- The transfer of large liability balances outside the banking system could complicate monetary-policy transmission at a time when accommodative-policy tapering already poses significant challenges. Liquidity shocks exacerbated by securities "fails" or other market disruptions resulting from low cash holdings at custody banks could also adversely affect fiscal-policy execution, especially under stress scenarios.

As demonstrated in this study, institutional investors have a longstanding need for custody banks during periods of market stress and volatility, with large inflows apparent during the 2008 crisis, recent U.S. fiscal-policy crises, and other market shocks. However, data also demonstrate a long-term, clear trend towards an overall increase in cash deposits at U.S. custody banks. Normalized interest rates may drop these holdings to some extent, but an array of new rules that reduce the supply of cash-equivalents (e.g., U.S. Treasury obligations) makes it likely that institutional investors will continue to need large amounts of cash housed as safely as possible.

"Custody banks are the safe harbor regulators have long relied upon to handle safekeeping and they need them now more than ever," Petrou said. "In the wake of the financial crisis, investors rely even more than before on asset-management companies, and asset-management companies need custody banks to absorb cash deposits and ensure resilience under stress," she continued. "If custody banks are unnecessarily constrained, then market resilience clearly suffers."

This study was funded by State Street, but the bank did not dictate its content or methodology. FedFin retained control over the paper at all times and its findings and views represent the firm's views based on its own research.

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