American Bankers Association

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Office of the Comptroller of the Currency
400 7th Street, S.W., Suite 3E-218
Mail Stop 9W-11
Washington, D.C. 20219
Attention: Legislative and Regulatory Activities Division

Board of Governors of the Federal Reserve System
20th Street & Constitution Avenue, N.W.
Washington, D.C. 20551
Attention: Robert de V. Frierson, Secretary

Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, D.C. 20429
Attention: Robert E. Feldman, Executive Secretary

Re: Comments in Response to the Notice of Proposed Rulemaking – *Net Stable Funding Ratio: Liquidity Risk Measurement Standards and Disclosure Requirements*

Ladies and Gentlemen:

The American Bankers Association (ABA)[1] appreciates the opportunity to comment on the joint notice of proposed rulemaking (the Proposal) of the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the Board of Governors of the Federal Reserve System (collectively, the Agencies), to implement the net stable funding ratio (NSFR), one of two Basel III liquidity standards, in the U.S.[2] The Proposal would require banking organizations with over $250 billion in assets, or $10 billion or more in foreign exposure, to maintain a minimum level of stable funding relative to the liquidity of their assets, derivatives, and commitments, over a one-year period. The Federal Reserve would also require banking organizations with $50 billion to $250 billion in assets to comply with a less stringent, modified NSFR requirement.

[1] The American Bankers Association is the voice of the nation's $16 trillion banking industry, which is composed of small, regional and large banks that together employ more than 2 million people, safeguard $12 trillion in deposits and extend more than $8 trillion in loans.

[2] In response to liquidity weakness seen during 2007 and 2008, the Basel Committee on Bank Supervision (Basel) introduced a global liquidity framework to strengthen liquidity risk management by proposing two quantitative liquidity standards: the liquidity coverage ratio (LCR) and the net stable funding ratio. The LCR requires firms to hold a buffer of monetizable assets that may replace funds lost over an assumed 30-day stressed period. The NSFR, intended to complement the LCR, is a structural funding measure, intended to require firms to hold a minimum amount of stable funding over a longer period. The Proposal would implement the NSFR in the U.S. The U.S. LCR rule was finalized in 2014.

Prudent and effective management of liquidity risk is a fundamental aspect of bank safety and soundness. Accordingly, ABA supports the Agencies' ongoing efforts to ensure that banks, and the financial system as a whole, are adequately positioned to withstand future events, including liquidity shocks. However, for the reasons we outline below, ABA believes that the Agencies should reconsider implementing the NSFR in the United States.

Fundamentally, the NSFR is superfluous. The risks the Proposal seeks to cover are already mitigated by the ample body of regulatory standards and data collections implemented in the U.S. since 2009, when work on the NSFR was first undertaken in Basel. In the intervening years, many enhancements to liquidity regulation and supervisory liquidity monitoring have been adopted domestically, including the following directed specifically at liquidity[3]:

- The Liquidity Coverage Ratio (LCR)
- The Comprehensive Liquidity Assessment and Review (CLAR)
- The Method 2 GSIB surcharge calculation
- Complex institution liquidity reporting (Form FR 2052a)
- Liquidity stress testing and other requirements of Section 165 of the Dodd-Frank Act (including Resolution Plans)

As part of its own efforts to improve liquidity risk management and in response to these regulatory initiatives, the banking industry has worked hard to make liquidity risk monitoring and mitigation significantly more robust. Given this substantial regulatory framework already in place in the United States, it is unclear why the NSFR is necessary or why the supervisory process is insufficient to address any remaining firm-specific matters. It is hard to discern any value that the NSFR brings to bank supervision or bank management not already provided by other regulatory tools and practices. In effect, the purposes of the NSFR are already achieved in the United States, and it would be wholly appropriate for U.S. prudential regulators to so find.

Moreover, the details of the NSFR are out of date or otherwise structurally and fundamentally flawed. We discuss below some of our reasons for that belief. In order to improve liquidity supervision and management we propose a technical correction to the LCR. Further, we highlight our concerns with the Basel process through which the NSFR was conceived. We also support the more technical and detailed discussion in the comment letter submitted jointly by ABA and others including, The Clearing House Association L.L.C., the Securities Industry & Financial Markets Association, The Financial Services Roundtable, The Institute for International Banking and the CRE Finance Council.

The NSFR Is Structurally Flawed

The NSFR is fundamentally, structurally flawed in that it confuses available liquidity in short-term stress with long-term funding needs. ABA is concerned that the proposed NSFR relies heavily and injudiciously on assumptions and definitions contained within the LCR, which was designed for different purposes and conditions. Assumptions about asset liquidity and counterparty behavior during a severe short-term stress—what the LCR is designed to measure—are not applicable to a structural balance sheet measure like the NSFR that generally assumes normal business conditions over the long-term. Not only is reliance on LCR definitions misplaced, but the LCR definitions themselves do not yet

[3] Additionally, we note the pending Total Loss Absorbing Capacity (TLAC) rules.

reflect any stressed reality that the U.S. economy has seen or can reasonably expect. ABA has consistently advised that the LCR is overly and dangerously narrow and prescriptive and not based on robust and broad analysis of U.S. funding and asset liquidity experience. Its effects will be to discourage core banking activities such as certain lending and deposit taking, results not explored nor even acknowledged in the LCR and its regulatory implementation.[4]

Then, where consistency between the two liquidity measures would be expected, we too often find it absent. For example, were the agencies to consider maintaining some linkage between the two ratios for practical reasons, the agencies should then consider the fact that in order for the NSFR to be credible, the assumptions about funding and liquidity characteristics should be logically consistent across the ratios. That means that, as a starting point, if the LCR assumes a run-off of for example 10 percent, the NSFR's available stable funding factors should at a minimum be its inverse, or 90 percent. Similarly, on the asset side, one would expect that assumed haircuts would be comparable under both the LCR and NSFR. There are several instances where this is not the case, and the NSFR is curiously more severe. Consider the following as illustrative of the problem:

- **Treasury Securities.** The LCR assumes that level 1 securities are cash equivalent, while the NSFR assumes that these securities will receive a 5 percent haircut. If the same security is used to secure a loan from a financial sector entity, then it is given a 10 percent haircut. Additionally, if the level 1 securities are received as variation margin the effective haircut is 100%. No explanation is given as to why the liquidity characteristics of a Treasury security would change across either the LCR or NSFR or within the NSFR itself.

- **Operational Deposits.** The LCR correctly acknowledges the unique and highly stable nature of operational deposits, assigning these funds a lower (but still punitive) 25 percent run-off rate. Logic would dictate within that view that operational deposits also receive a 75 percent stable funding weight in the NSFR. Instead, the Basel committee – and also, without explanation, the Agencies - assign a 50 percent available stable funding factor. Not only is this asymmetric, but it is fundamentally inconsistent with the actual experience of U.S. institutions, which are the foremost providers of the services from which these deposits are derived (i.e. clearing, custody, and cash management). Additionally, we note that the stable funding factor differs from the results of firms' Dodd-Frank Act mandated-stress testing, which indicate these funds are more stable than either the NSFR or LCR allows.

- **Non-deposit Retail funding.** Under the LCR, non-deposit retail funds (a category which includes pre-paid products) receive a 40 percent outflow rate.[5] The proposed NSFR, however, assigns a zero percent available stable funding factor to these products. This treatment does not align with the historical performance of these funds, which *typically are stable through economic cycles*. Furthermore, the Proposal notes that the availability of federal deposit insurance can be a stabilizing factor preventing the outflow of retail

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[4] See e.g., Testimony of Wayne Abernathy before the Banking, Housing, and Urban Affairs Committee, United States Senate (June 23, 2016), ABA letter on allowing certain municipal securities to qualify as HQLA (July 24, 2015), ABA comment letter on the LCR (January 31, 2014), Joint Trade letter on the LCR, (January 31, 2014)

[5] 12 C.F.R. § 249.32(a)(5).

> deposits during times of stress[6] and, importantly, many prepaid products provide customers with the protection of FDIC pass-through insurance. Given these characteristics, these funds should be considered stable funding. The NSFR does not even assign to them the logically consistent (though experientially severe) inverse treatment as under the LCR, or a 60 percent available stable funding factor.

Moreover, a static ratio that only provides a snapshot in time does not accurately reflect a bank's funding risk, nor the significant potential to replace lost business over the longer term. Accordingly, the NSFR should recognize that a firm will make balance sheet adjustments to offset funding outflows over the course of a year and a firm's ability to anticipate its funding needs over a longer, normal course of business scenario. This is one of many examples of how the static assessments of the NSFR (and of the LCR, we would add) are inconsistent with the demonstrated dynamic realities of financial liquidity.

Another shortcoming of the NSFR compared with U.S. financial experience is its treatment of what are broadly defined as "brokered deposits." The NSFR Proposal fails to treat brokered retail deposits as comparable to retail funding, although in U.S. experience they perform much the same in stress conditions. Moreover, as a general matter, we remain concerned about the FDIC's broad interpretation of brokered deposits. As we have noted previously,[7] brokered deposits are not *ipso facto* unstable or used for imprudent purposes. It is important, then, that the FDIC take a more nuanced view of brokered deposits that aligns with congressional intent, modern safe and sound banking practices, and the evolution in structure and practice of bank funding instruments that the FDIC continues to coral within its broad definition of brokered deposits. The FDIC may feel bound by statute as to how it defines "brokered deposits," but the statute does not require the application of an obsolete procrustean definition in the case of liquidity standards, which need to be based upon experience and an evolving reality, not artificial and inaccurate definitions. A broad classification of deposits as "brokered" creates unnecessary costs, as the penalty for holding "brokered" deposits flows through to other regulatory initiatives, such as those for deposit insurance, the LCR and the proposed NSFR.

Additionally, ABA believes that the treatment of "other retail brokered deposits" is overly conservative and does not reflect the stability of these funds. The Proposal would assign a factor of 50 percent to unaffiliated brokered sweeps while assigning a 90 percent factor to affiliated brokered sweeps even when contractual features provide for additional stability of the deposits. ABA believes that the Proposal's approach is overly punitive. It would be more appropriate to treat them in a manner similar to affiliated sweeps, which receive a 90 percent ASF factor. Similarly, fully insured brokered term deposits, in many cases do not allow for depositors to redeem the deposit prior to maturity except for in limited circumstances such as estate features and are not subject to market making by the issuing bank. Given these contractual provisions, a 100 percent ASF factor in line with the stability of the deposit

The LCR Is Not Properly Calibrated to U.S. Experience

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[6] *See, e.g.,* Proposed Rule at 35136 ("The proposed rule would assign a lower ASF factor to deposits that are not entirely covered by deposit insurance relative to that assigned to stable retail deposits because of the elevated risk of depositors withdrawing funds if they become concerned about the condition of the bank, in part, because the depositor will have no guarantee that uninsured funds will promptly be made available through established and timely intervention and resolution protocols").

[7] See ABA Response to EGRPRA Fourth Request for Comments (March 2016), Joint-trades letter to FDIC in response to FAQs on Brokered Deposits (January 2016)

We appreciate the Agencies' attention to the necessary revision of certain LCR definitions, particularly with respect to collateralized fiduciary deposits held by state chartered institutions. ABA believes that the LCR needs substantive refinement to make it a more accurate measure of a firm's liquidity risk, particularly a firm operating in the liquidity ecosystem of the United States. In keeping with this reasonable approach, we further encourage the Agencies, as one of the needed steps for improving the implementation of the LCR, to amend the definition of "Retail customer or counterparty" to capture better the liquidity risk of deposits made on behalf of personal trusts (i.e., trusts created for family or charitable purposes).

The fundamental flaws of the LCR would be exacerbated by the layering on of the NSFR, which uses and thereby reinforces the flawed LCR definitions. The source of the problem is that the LCR is a result of international negotiations the standards of which, when applied to the U.S., were not properly calibrated to reflect U.S. financial, legal, and market conditions and the practices and attitudes of the people who live and work within those conditions. In significant ways the LCR little accords with the actual, discernable risks that a U.S. banking organization faces in U.S. markets. Liquidity problems are at their core about panic, and panic is a local, idiosyncratic matter, affected by local laws, national financial and legal structures, customs, and popular attitudes. Globally negotiated and determined treatments, in order to be relevant and valuable rather than irrelevant and disruptive, need to be tailored in their implementation to fit the realities in the United States. In important ways, the LCR fails to do so, and the NSFR replicates those problems (along with introducing its own).

One of the most glaring errors is the failure to recognize the demonstrable and almost invariable experience, that U.S. banks are seen as safe havens in times of stress, both for domestic and even global customers—extending even to foreign governments. During the recent recession, U.S. banks saw an influx of almost a trillion dollars of deposits beginning from the onset of the recession in December 2007 until its official end in June 2009.[8] The LCR, however, as applied in the U.S., requires U.S. banks to assume significant deposit *outflows*, which is the opposite of the U.S. experience. The result is not only wrong, it is disruptive to traditional banking patterns and undermines bank operations, customer relationships, and economic growth.

As another example, the LCR discourages collateralized deposits, such as those from state and local municipalities. These deposits are required by state law to be collateralized and receive a double penalty under the LCR as banks are required to hold additional high quality liquid assets (HQLA) against them. The added costs are making key banking services more expensive for municipalities and causing some banks to exit this business altogether. Treating those deposits based on the nature of the collateral supporting them ignores the effects of state laws and turns on its head the important depositor relationship between banks and state and local governments. Instead, the Agencies should treat collateralized deposits as other deposits, taking into consideration the demonstrated historical behavior of the depositor, or even more appropriately exclude them from the LCR altogether.

A further example is the treatment of retail trust by the LCR that does not reflect the nature or behavior of the deposits. Section 3 of the LCR defines a "retail customer or counterparty" as an individual or business customer that meets specific criteria. When finalizing the LCR, the Agencies recognized that certain trusts exhibit the same behavior as a retail depositor and may be the "alter ego" of the grantor.[9] However, the regulation so narrowly defines retail trusts that it excludes common trust arrangements

[8] Call reports, also FDIC's QBP reports.
[9] 79 Fed. Reg. 61440, 61482 (October 10, 2014).

that are also akin to a natural person. As a result, many deposits made on behalf of trusts are improperly subject to wholesale treatment.

Section 3 of the LCR offers as a definition of retail living or testamentary trust that it—

> (i) Is solely for the benefit of natural persons;
> (ii) Does not have a corporate trustee; and
> (iii) Terminates within 21 years and 10 months after the death of grantors or beneficiaries of the trust living on the effective date of the trust or within 25 years, if applicable under state law.

ABA proposes that this definition be revised to read as follows:

> (3) A living or testamentary trust with a natural person as trustee or a natural person who has the power to revoke the trust, remove the trustee, or direct the trustee.

Our proposed language addresses both the Agencies' concerns (1) with trusts that behave like institutions and (2) that certain personal trusts that do not meet the existing definition are nonetheless similar to other retail depositors and should be treated as such.

The rationale for our approach follows closely with the reasoning in the Securities and Exchange Commission's (SEC) money market mutual fund reforms.[10] The SEC, similarly concerned with liquidity of their regulated prime money market funds, created a new category of fund limited to "retail investors." The test for a retail investor requires that a natural person have "investment power" over the security, which includes "the power to dispose, or to direct the disposition of, such security."[11] Hence a revocable trust, even with a corporate trustee and with non-natural beneficiaries such as schools and charitable entities, may invest in a retail fund. The account is considered as retail because the grantor, who has the ability to revoke the trust, has "investment power." Similarly, if an irrevocable trust has two co-trustees, one being corporate and the other a natural person, the account still may be deemed "retail" because the natural person co-trustee has "investment power."

We believe that the SEC's framework for determining a retail investor works equally well with respect to a retail depositor. The question should not be whether the trust has a corporate trustee or charitable beneficiaries, but whether a natural person has the ability to make decisions about the deposit account as a co-trustee, a grantor of a revocable trust, or as a trust director with investment authority.

The LCR Introduces Significant Systemic Risk

A fundamental problem, one that introduces significant systemic risk into the U.S. economy, is that the definition of HQLA remains far too narrow. The constricted definition of HQLA fails to recognize the important and valuable depth and breadth of U.S. financial markets and the liquidity value of many non-sovereign instruments, and in the process will create important market distortions in good times and acute shortages of HQLA in times of stress.[12] Specifically, the narrow definition of HQLA will cause all firms to seek to draw from the same well of HQLA in good times and in bad. In the draughts of financial stress, participants—particularly those who are less involved in the day-to-day markets for HQLA instruments—will find the queues to the well long and the well close to dry when they get their

[10] 15 CFR 270.2a–7.

[11] See OCC Bulletin 2016-17 for a good summary of the reforms.

[12] This is particularly acute in light of money market reforms, and other recent financial regulatory initiatives that mandate the use of Treasury securities

turn, as those in front will take and keep as much HQLA as they can, unsure of what evolving regulatory views will demand of them. Panic is caused when actors doubt their ability to obtain what they think they very much need. Further, discouraging bank investment in debt securities other than Treasuries decreases daily operating liquidity in disfavored markets, such as those for municipal securities, corporate debt, and secondary mortgages, among others.

We once again strongly urge the Agencies to provide a mechanism to recognize the dynamism of U.S. markets by allowing for future asset classes to be available for liquidity management purposes. We applaud the Federal Reserve for allowing some municipal securities to qualify as HQLA, and we again request that the OCC and FDIC follow suit. That alone will not solve the problem of a too-narrow HQLA, but it will help. Ultimately, a more dynamic definition of HQLA is needed, one that recognizes the truth that any financial instrument has the potential for liquidity shortcomings, that many instruments from time to time can serve well to alleviate liquidity problems, and that overall a greater diversity of liquidity instruments is preferable to a narrow definition and constrained supply.

The Basel Process is Opaque and Does not Allow Sufficient Public Engagement

The problems we raise about the NSFR, and the elements of the LCR on which it relies, are due in large part to the deficiencies in the international process that resulted in the problematic introduction of these regulatory proposals into the United States. We have often advised that regulations formulated overseas without the benefit of early public notice and comment in the United States do not reflect the features or fit the needs of the U.S. economy.[13] The LCR is only one, albeit grave, example of not being properly calibrated to U.S. financial and economic experience and conditions. Public comment in the United States, at the outset of consideration of the global financial standards, would have allowed for a better set of global liquidity standards and an implementation by the Agencies in the U.S. better tailored to U.S. financial and economic realities, markets, financial customers, and the institutions that serve them.[14]

The Basel process itself labors under an opacity caused by its structure and remoteness from the U.S. public, policymakers, and financial participants. Moreover, the length of the Basel standard setting process and sheer complexity of the issues covered typically means that by the time the standards reach the United States, regulatory consensus has been formed, trade-offs have been negotiated, commitments made, global understandings reached, with little room viewed by the Agencies to make adjustments more appropriate for U.S. conditions.

In order to ensure that important and complex international financial standards are properly evaluated through early public engagement, we strongly encourage the Agencies to follow a practice of issuing an Advance Notice of Proposed Rulemaking (ANPR) at the onset of an international standard setting deliberation. In so doing, the process would commence with a public clarity about the purpose of a given standard, and those affected can offer comments and technical input before policy is set. Importantly, the ANPR process would provide feedback to Agencies so that they are more fully informed as to the issues and the implications for U.S. financial services customers and providers when the Agencies first engage in discussions with their international counterparts. Furthermore, while Basel standards are typically calibrated to the activities of large, international banking organizations, the

[13] see ABA comment letter on Basel III (November 2013) and ABA comment letter on the standardized approach (April 3, 2015)

[14] We note that the LCR and NSFR were first proposed by Basel in 2010 (http://www.bis.org/publ/bcbs188.pdf) with the US proposals introduced in 2013 and 2016, respectively.

standards when applied in the U.S. often impact smaller institutions, either directly or indirectly by altering domestic markets for bank funding, assets, and investments, and changing supervisory views and practices. It is particularly important that all institutions, policy makers and other stakeholders understand the standards as they are being developed internationally.

It is also important that any Basel standard be grounded on sound empirical analysis. Sufficient empirical justification for a given standard is often not provided through Basel's consultative process or related U.S. rulemaking.[15] Currently, many Basel standards are calibrated using point-in-time quantitative impact study (QIS) data from a handful of global institutions. The data and subsequent analysis do not adequately consider country specific factors, evaluate future financial environments, and overlook the impact of the standard on the firms that will be scoped into the rule domestically but do not participate in the QIS. Forward looking analysis is particularly important in the current, historically abnormal period, particularly with respect to liquidity and interest rate environments.

We strongly encourage the Agencies to use the plentiful data available from current banking organization reporting, and ongoing supervisory initiatives to determine the appropriate scope of a given rule and the overall cost or benefit a given standard has on firms and their customers as well as on U.S. markets and the economy. Available data would also allow aid the agencies in ensuring that any rulemaking is properly tailored to institutions exposed to the risks the Agencies wish to mitigate.

Thank you for considering the comments and recommendations set forth in this letter. If you have any questions or need further information, please do not hesitate to contact the undersigned at atouhey@aba.com; 202-663-5182.

Sincerely,

Alison Touhey
Senior Regulatory Advisor

[15] As an example, The NSFR's derivative add-on, which is passed through to the US proposal, did not appear in any Basel consultation and was introduced in the final rule with limited context regarding its origin, appropriateness or benefit.