January 31, 2014

Department of the Treasury
Office of the Comptroller of the Currency
400 7th Street SW, Suite 3E-218, Mail Stop 9W-11
Washington, DC 20219
Attn: Legislative and Regulatory Activities Division
Docket ID OCC-2013-0016

Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue NW
Washington, DC 20551
Attn: Robert deV. Frierson, Secretary
Docket No. R-1466

Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429
Attn: Comments / Legal ESS
Robert E. Feldman, Executive Secretary
RIN No. 3064-AE04

VIA ELECTRONIC MAIL: regs.comments@federalreserve.gov; comments@fdic.gov; regs.comments@occ.treas.gov

Re: Liquidity Coverage Ratio: Liquidity Risk Measurement, Standards, and Monitoring, 78 Fed. Reg. 71,818 (the "**Proposed Rule**")

Dear Sir or Madam:

The Committee on Capital Markets Regulation (the "**Committee**") is grateful for the opportunity to comment on the Proposed Rule,[1] released jointly by the Board of Governors of the Federal Reserve System (the "**Board**"), the Federal Deposit Insurance Corporation (the "**FDIC**"), and the Office of the Comptroller of the Currency (the "**OCC**," and together with the Board and the FDIC, the "**Agencies**").

Founded in 2006, the Committee is dedicated to enhancing the competitiveness of U.S. capital markets and ensuring the stability of the U.S. financial system. Our membership includes thirty-three leaders drawn from the finance, investment, business, law, accounting, and academic communities. The Committee is chaired jointly by R. Glenn Hubbard (Dean, Columbia Business School) and John L. Thornton (Chairman, The Brookings Institution) and directed by Hal S. Scott (Nomura Professor and Director of the Program on International Financial Systems, Harvard Law School). The Committee is an independent and nonpartisan 501(c)(3) research organization, financed by contributions from individuals, foundations, and corporations.

[1] Liquidity Coverage Ratio: Liquidity Risk Measurement, Standards, and Monitoring, 78 Fed. Reg. 71,818 (proposed Nov. 29, 2013).

The Proposed Rule seeks to implement a quantitative liquidity coverage ratio ("**LCR**") based on the international blueprint (the "**Basel III LCR**")[2] set forth by the Basel Committee on Banking Supervision (the "**Basel Committee**") with respect to (i) large, internationally active banking organizations, (ii) nonbank financial companies designated for Board supervision by the Financial Stability Oversight Council ("**non-bank SIFIs**") that do not engage in substantial insurance activities, and (iii) consolidated subsidiary depository institutions with total assets of greater than $10 billion ("**covered organizations**").[3] The Committee has extensively commented on singling out non-banks for Board supervision and regulation, and generally opposes the application of bank-specific prudential standards to non-banks.

The Proposed Rule would be the first such quantitative liquidity standard imposed on U.S. banking organizations.[4] It would require covered organizations to hold minimum stocks of "high quality liquid assets" ("**HQLA**") that could be sold or pledged as collateral to accommodate a sudden surge of withdrawals by depositors and other short-term debt holders in stressed liquidity scenarios.[5] The Proposed Rule would complement the qualitative liquidity requirements proposed by the Board pursuant to section 165 of the Dodd-Frank Act, which require minimum stocks of HQLA based on internally developed stress models and the establishment of certain liquidity risk management policies and procedures, including the requirement to form a liquidity risk committee.[6] This letter provides the Committee's views on the proposed LCR with respect to covered organizations with $250 billion or more in consolidated assets or $10 billion or more in foreign exposures.

The Committee commends the Agencies for their focus on systemic risk, and we support in principle the introduction of an LCR along the lines set forth by the Basel Committee as a meaningful contribution to improving the resiliency of covered organizations. However, we believe that the Proposed Rule alone is not a complete solution to the ongoing threat of financial contagion without the necessary backstop of strong central bank lender of last resort authority. First, the Proposed Rule would not and could not guarantee that covered organizations hold sufficient HQLA to pledge or sell in private markets to meet withdrawals by short-term creditors in the event of a contagious run. Second, the Proposed Rule would unnecessarily increase the cost of capital for covered organizations by reducing their capacity to lend long-term to U.S. consumers and businesses. The Committee believes that restoring and strengthening the Board's lender of last resort authorities is a far more effective and efficient alternative to private liquidity reserves.

---

[2] *See* Basel Committee, *Basel III: International Framework for Liquidity Risk Measurement, Standards and Monitoring* 1 (Dec. 2010), http://www.bis.org/publ/bcbs188.htm; *see also* Basel Committee, *Basel III: The Liquidity Coverage Ratio and Liquidity Risk Monitoring Tools* 1 (Jan. 2013), http://www.bis.org/publ/bcbs238.htm.
[3] Liquidity Coverage Ratio: Liquidity Risk Measurement, Standards, and Monitoring, 78 Fed. Reg. 71,818 (proposed Nov. 29, 2013).
[4] *Id.* at 71,820.
[5] *Id.*
[6] *See* Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies, 77 Fed. Reg. 594 (proposed Jan. 5, 2012).

Additionally, the Proposed Rule's definition of HQLA is narrower than the Basel III LCR and corresponding European Banking Agency proposal ("**European Proposal**"),[7] and the liquidity stress scenario is also substantially more severe. For example, the Proposed Rule would implement a "worst-day" stress scenario (essentially, a single day stress scenario) as compared to the Basel III LCR's 30-day scenario.[8] The Agencies have failed to provide any empirical evidence that this divergence from international standards is necessary to improve the liquidity position of covered organizations. The Committee therefore strongly urges the Agencies to revise the Proposed Rule to restore consistency with the emerging international standards and prevent covered organizations from being placed at a competitive disadvantage *vis-à-vis* their foreign peers.

Summary of the Proposed Rule

The Proposed Rule would require all covered organizations to maintain a minimum LCR of 100%, calculated by dividing a bank's HQLA by its total net cash outflow amount over a 30-day period.[9] In order for an asset to qualify as HQLA, it must be liquid and readily marketable, a reliable source of funding in repurchase agreement or sales markets, and not an obligation of a financial company.[10] A standard stress scenario would assign specific outflow amounts to different categories of a bank's funding.[11] Importantly, during an idiosyncratic or systemic liquidity crisis, the Proposed Rule would allow a covered organization to convert its HQLA into cash as necessary to meet withdrawals by short-term creditors, even if this required falling well below the minimum LCR.[12]

The Proposed Rule further divides a covered organization's HQLA into three categories. "Level 1" liquid assets are of the highest quality and most liquid and thus may be counted toward a bank's HQLA at their full fair values.[13] Level 1 liquid assets include: (i) excess reserves held at the Federal Reserve; (ii) reserves held at a foreign central bank and subject to withdrawal; (iii) securities issued by, or guaranteed by the full faith and credit of, the U.S. government; and (iv) certain securities that are claims guaranteed by a sovereign entity, a central bank, or other international entities that are assigned a 0% risk weight under the standardized approach of the revised regulatory capital rules.[14]

"Level 2" assets have been deemed sufficiently stable to warrant some credit towards HQLA but are subject to haircuts and when combined cannot exceed 40% of the total stock of HQLA.[15] "Level 2A" liquid assets are subject to a 15% haircut[16] and include claims on, or claims

---

[7] *See* European Banking Authority, *Report on Appropriate Uniform Definitions of Extremely High Quality Liquid Assets (Extremely HQLA) and High Quality Liquid Assets (HQLA) and on Operational Requirements for Liquid Assets under Article 509(3) and (5) CRR* 1 (Dec. 20, 2013), *available at* http://www.eba.europa.eu/-/eba-publishes-reports-on-liquidity.

[8] Liquidity Coverage Ratio: Liquidity Risk Measurement, Standards, and Monitoring, 78 Fed. Reg. 71,818, 71,833 (proposed Nov. 29, 2013).

[9] *Id.* at 71,822.

[10] *Id.* at 71,824.

[11] *Id.* at 71,833.

[12] *Id.* at 71,822.

[13] *Id.* at 71,825.

[14] *Id.* at 71,825-71,826.

[15] *Id.* at 71,823.

[16] *Id.*

guaranteed by, a U.S. government sponsored enterprise and claims on, or claims guaranteed by, a sovereign entity or a multilateral development bank that are assigned a 20% risk weight under the standardized approach of the revised regulatory capital rules.[17] "Level 2B" liquid assets are subject to a 50% haircut and generally include (i) investment-grade, publicly-traded corporate debt securities and (ii) publicly-traded equities that are included in the Standard & Poor's 500 Index or an equivalent index that meets the satisfaction of the relevant supervisor.[18]

The Proposed Rule's outflow rates are designed to distinguish stable funding sources from those that are more volatile. Unsecured retail funding outflows range from 3% for stable retail deposits that are fully FDIC-insured[19] to 40% for uninsured retail brokered sweep deposits.[20] Unsecured wholesale funding proposed outflow rates would range from 25% for certain operational deposits (where a banking organization provides services that require its customers to maintain certain deposit balances with the banking organization, making the deposit more stable) to 100% for commercial paper or non-operational deposits from financial entities.[21] Secured, short-term funding outflow rates would increase progressively from 0% for secured funding backed by Level 1 liquid assets to 100% for secured funding backed by non-HQLA.[22]

The Proposed Rule would permit a covered organization to offset its total stressed cash outflows with stressed cash inflows, up to 75% of its total stressed cash outflows.[23] Stressed cash inflows include contractual inflows, including interest payments, from fully performing outstanding exposures.[24]

Rationale of the Proposed Rule

The Agencies have issued the Proposed Rule in order to prevent a recurrence of perceived "lapses in basic liquidity risk management practices" that contributed to the weak "liquidity positions of banking organizations" during the 2008 financial crisis.[25] According to the Agencies, several of the largest U.S. bank holding companies lacked sufficient HQLA to sell or pledge in the private market to meet the demands of short-term creditors that were rapidly withdrawing funding.[26] In order to halt the run by short-term creditors, the Federal Reserve intervened as lender of last resort, providing banks with unprecedented liquidity support, and the FDIC guaranteed the short-term creditors of large U.S. bank holding companies.

The Committee agrees with the Agencies that the Proposed Rule would "improve the banking sector's ability to absorb . . . shocks arising from financial and economic stress"[27] and increase the resiliency of financial companies. However, the Committee believes that the Proposed Rule would not and could not guarantee that covered organizations would hold

[17] *Id.* at 71,826-71,827.
[18] *Id.* at 71,827-71,828.
[19] *Id.* at 71,835.
[20] *Id.* at 71,840.
[21] *Id.* at 71,841-71,842.
[22] *Id.* at 71,864.
[23] *Id.* at 71,833.
[24] *See Id.* at 71,843-71,844.
[25] *Id.* at 71,820.
[26] *Id.*
[27] *Id.*

sufficient HQLA to sell or pledge in private markets to meet the withdrawals of short-term creditors in the event of another contagious run.

Because a covered organization's stock of HQLA is necessarily limited, it is always possible that a run by short-term creditors could overwhelm even the strongest portfolio. Thus, short-term creditors of a covered organization with a large stock of HQLA would still have an incentive to withdraw funding sooner—while the portfolio of HQLA is still intact—rather than later, after waves of withdrawals have exhausted it. Moreover, requiring a covered organization to hold a portfolio of HQLA does not ensure its solvency absent contagion. Thus, if short-term creditors fear that a covered organization is insolvent, they will still withdraw their funding. Indeed, the Agencies do not contend that the amount of HQLA required by the Proposed Rule would have been sufficient to allow large U.S. bank holding companies to meet the demands of short-term creditors in 2008.

The Committee believes that a strong lender of last resort authority is the sole method effective in forestalling a contagious run by short-term creditors. Indeed, the availability of a strong lender of last resort almost ensures that a central bank will rarely (if ever) have to use its power.[28] Providing emergency liquidity to the financial system exclusively through private reserves is less efficient than central bank emergency lending, as every dollar of capital allocated to the low-yielding, liquid, short-term securities that qualify as HQLA is unavailable to finance longer-term lending to U.S. consumers and businesses. Indeed, the Agencies have estimated that the Proposed Rule would require covered organizations to hold $2 trillion in HQLA, with a current shortfall of $200 billion.[29]

Proposed Rule and Basel III LCR

One of the most significant differences between the Proposed Rule and Basel III LCR lies in the assumed runoff rates for short-term creditors without a specific maturity date, including uninsured retail and wholesale depositors, the primary source of short-term funding for covered organizations.[30] The Proposed Rule assumes that these short-term creditors would withdraw their funding immediately on Day 1, whereas the Basel III LCR implicitly assumes that these funds are withdrawn at a constant rate through Day 30.[31] For example, the Proposed Rule would assume that 100% of certain unsecured non-operational wholesale depositors and 25% of unsecured operational deposits are withdrawn on Day 1, whereas the Basel III LCR assumes that these same creditors runoff at a constant rate, only reaching cumulative withdrawals of 100% of unsecured wholesale deposits and 25% of unsecured operational deposits on Day 30.

---

[28] *See* William C. Dudley, President and Chief Executive Officer of the Federal Reserve Bank of New York, Remarks at the New York Bankers Association's 2013 Annual Meeting & Economic Forum (Feb. 1, 2013), *available at* http://www.newyorkfed.org/newsevents/speeches/2013/dud130201.html.

[29] David Emmel, Manager, Board of Governors of the Federal Reserve System, Comment at Open Meeting on Quantitative Liquidity Requirements (Oct. 24, 2013).

[30] *See* William C. Dudley, President and Chief Executive Officer of the Federal Reserve Bank of New York, Remarks at the New York Bankers Association's 2013 Annual Meeting & Economic Forum (Feb. 1, 2013), *available at* http://www.newyorkfed.org/newsevents/speeches/2013/dud130201.html.

[31] Liquidity Coverage Ratio: Liquidity Risk Measurement, Standards, and Monitoring, 78 Fed. Reg. 71,818, 71,833 (proposed Nov. 29, 2013).

The Proposed Rule would therefore require covered organizations to hold substantially more HQLA than the Basel III LCR, as any inflows after Day 1 would not reduce the required amount of HQLA. Indeed, even during the acute phase of the 2008 financial crisis, the largest U.S. banking organizations did not experience a single day 100% runoff by unsecured wholesale depositors. In fact, withdrawals of this magnitude are impossible, as the U.S. Automated Clearing House system, an integral component of the U.S. payments systems, simply could not process outflows at the rates assumed under the Proposed Rule.

The Proposed Rule's runoff rate for custodial deposits by mutual funds and other collective investment funds (excluding prime brokerage arrangements) is also a notable divergence from the Basel III LCR and entirely lacking in empirical support. Although the Basel III LCR would impose a 25% runoff rate on such custodial deposits,[32] the Proposed Rule would exclude these deposits from the definition of "operational deposits," thereby imposing a 100% runoff rate on this important source of funding.[33] The Proposed Rule's runoff rates are inconsistent with the rates for custodial deposits by mutual funds and collective investment funds without a contractual maturity during the 2008 crisis.

The Proposed Rule does not include residential mortgage backed securities or state or municipal bonds under the definition of HQLA,[34] whereas the Basel III LCR and the European Proposal generally permit their inclusion as Level 2 assets subject to a 25% and 15% haircut, respectively.[35] Additionally, the Proposed Rule would apply a 50% haircut to high-quality publicly traded corporate debt,[36] whereas the Basel III LCR and the European Proposal would only apply a 15% haircut to corporate debt of comparable liquidity and quality.[37]

There are numerous other deviations from Basel III, including the application of higher runoff rates to deposits by municipalities,[38] an accelerated timeline for U.S. implementation compared to the Basel III implementation timeline,[39] and burdensome daily reporting

[32] Basel Committee, *Basel III: The Liquidity Coverage Ratio and Liquidity Risk Monitoring Tools* 1, 24 (Jan. 2013), http://www.bis.org/publ/bcbs238.htm.
[33] Liquidity Coverage Ratio: Liquidity Risk Measurement, Standards, and Monitoring, 78 Fed. Reg. 71,818, 71,841 (proposed Nov. 29, 2013).
[34] *See Id.* at 71,860-71,862.
[35] Basel Committee, *Basel III: The Liquidity Coverage Ratio and Liquidity Risk Monitoring Tools* 1, 13-14 (Jan. 2013), http://www.bis.org/publ/bcbs238.htm.
[36] Liquidity Coverage Ratio: Liquidity Risk Measurement, Standards, and Monitoring, 78 Fed. Reg. 71,818, 71,823-71,827 (proposed Nov. 29, 2013).
[37] Basel Committee, *Basel III: The Liquidity Coverage Ratio and Liquidity Risk Monitoring Tools* 1, 13-14 (Jan. 2013), http://www.bis.org/publ/bcbs238.htm.
[38] *See* Liquidity Coverage Ratio: Liquidity Risk Measurement, Standards, and Monitoring, 78 Fed. Reg. 71,818, 71,827 (proposed Nov. 29, 2013); *see also* Basel Committee, *Basel III: The Liquidity Coverage Ratio and Liquidity Risk Monitoring Tools* 1, 13-14 (Jan. 2013), http://www.bis.org/publ/bcbs238.htm.
[39] *See* Liquidity Coverage Ratio: Liquidity Risk Measurement, Standards, and Monitoring, 78 Fed. Reg. 71,818, 71,822 (proposed Nov. 29, 2013); *see also* Basel Committee, *Basel III: The Liquidity Coverage Ratio and Liquidity Risk Monitoring Tools* 1, 2 (Jan. 2013), http://www.bis.org/publ/bcbs238.htm.

requirements.[40]

The Proposed Rule is thus substantially more stringent than the Basel III LCR and European Proposal and does not include any empirical basis to support the divergences from international standards. The Proposed Rule thus places covered organizations at a decided competitive disadvantage to their foreign counterparts, rendering covered organizations less able to lend to U.S. consumers and businesses.

The Committee therefore recommends that the Agencies harmonize the Proposed Rule with both the Basel III LCR and the European Proposal.

* * *

Thank you very much for your consideration of the Committee's position. Should you have any questions or concerns, please do not hesitate to contact the Committee's Director, Prof. Hal S. Scott (hscott@law.harvard.edu); its Executive Director of Research, C. Wallace DeWitt (cwdewitt@capmktsreg.org); or John Gulliver, Research Fellow (jgulliver@capmktsreg.org), at your convenience.

Respectfully submitted,

Robert Glenn Hubbard — John L. Thornton — Hal S. Scott

R. Glenn Hubbard	John L. Thornton	Hal S. Scott
CO-CHAIR	CO-CHAIR	DIRECTOR

[40] Liquidity Coverage Ratio: Liquidity Risk Measurement, Standards, and Monitoring, 78 Fed. Reg. 71,818, 71,822 (proposed Nov. 29, 2013).