



**AMERICANS
FOR FINANCIAL REFORM**
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Secretary
Board of Governors of the Federal Reserve System
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Robert E. Feldman
Executive Secretary
Attention: Comments/Legal ESS
Federal Deposit Insurance Corporation
550 17th Street NW
Washington, DC 20429

Re: Liquidity Coverage Ratio: Liquidity Risk Measurement, Standards, and Monitoring (Re: Docket IDOCC-2013-0016, Docket No. R-1466, RIN 3064-AE04)

Americans for Financial Reform (“AFR”) appreciates this opportunity to respond to the request for comments by the Federal Deposit Insurance Corporation, the Federal Reserve, and the Office of the Comptroller of the Currency (“the Agencies”) on their proposed rule for the Liquidity Coverage Ratio (“Proposed Rule”). AFR is a coalition of over 250 national, state, and local groups who have come together to advocate for reform of the financial industry. Members of AFR include consumer, civil rights, investor, retiree, community, labor, faith based, and business groups.

Liquidity requirements are a vital element of risk regulation. Liquidity spirals – or funding runs – are the most direct cause of bank failure and were the key failure mechanism for both institutions and broader markets in the 2008 crisis.¹ They are also a key complement to capital standards. In theory a well capitalized bank, even one engaged in significant amounts of maturity transformation, should be able to find funding even without a liquidity reserve. But in practice the opaque nature of bank balance sheets and the difficulty of asset valuation in periods of market stress mean that unless capital levels are extremely high counterparties will find it difficult to be certain of bank solvency in crisis periods. In contrast, a bank’s ability to meet its payment obligations is highly visible and immediately salient for counterparties. Ensuring

¹ Duffie, Darryl, How Big Banks Fail and What To Do About It, Princeton University Press, 2011.

adequate liquidity is thus vital for financial stability. Liquidity reserve requirements also help to counterbalance any incentive toward risk arbitrage that could emerge from a high leverage ratio alone.

AFR thus strongly supports the Agencies moving forward with the liquidity coverage ratio (LCR) proposed here. We are particularly supportive of the decision to make the U.S. LCR stronger in several important ways than the LCR proposed under the international Basel rules. The Agencies should not be deterred from this decision by arguments from the financial industry that there is a shortage of available liquid assets. The liquidity demands of this proposal are very small compared to the \$48 trillion global supply of high quality liquid assets, which is far greater than the demand generated not only new global liquidity rules but additional collateral demands from derivatives regulation as well.² Furthermore, any concerns regarding liquid asset supply could be addressed by permitting financial institutions to pay the Federal Reserve an up-front fee for a committed liquidity line, as has been done by the central bank in Australia.³

However, the 30-day LCR in this proposal can only be one element in a broader strategy to address liquidity issues in the financial system. The 30 day LCR is short-term and relies on a standardized stress test for liquidity demands that may not reflect specific bank exposures in a crisis situation. It also focuses on the individual institution and does not address some ways in which systemic liquidity stress can be created by large matched book dealers. We are encouraged that the Federal Reserve has stated that there are other liquidity-related rules under consideration such as the Net Stable Funding Ratio and rules addressing leverage in short-term funding markets. We urge the agencies to move ahead with strong rules in these areas as well.

Below, we specify several strengths of the proposed LCR that should be maintained in the Final Rule. We also specify several areas in which the proposed LCR appears weak and should be strengthened in the Final Rule, or where we feel the Agencies should consider additional issues for the Final Rule.

Strengths of the Proposed Rule

The Agencies have correctly chosen to strengthen the rule in several ways compared to the Basel LCR put forward by international regulators. Most importantly, the proposed U.S. LCR is based on the highest level of liquidity demands on any single day of a 30-day period (the ‘largest net cumulative cash outflow day’), rather than the net liquidity shortfall over the entire 30 day period. This means that liquidity demands must be managed over the entire period and prevents reliance on inflows over one part of the 30-day period to counterbalance outflows in another part. The experience of the 2008 crisis shows that the great majority of a bank’s liquidity pool can run off within just a few days. For example, Bear Stearns liquidity pool went from a fully provisioned \$18 billion to just \$2 billion between the 10th and the 13th of March, 2008.⁴ Later in

² Committee on the Global Financial System, “[Asset Encumbrance, Financial Reform, and the Demand for Collateral Assets](#)”, CGFS Papers No. 49, Bank for International Settlements, May, 2013.

³ Stein, Jeremy, “[Liquidity Regulation and Central Banking](#)”, Speech at the ‘Finding The Right Balance’ 2013 Symposium Sponsored By the Federal Reserve Bank of Richmond, April 19, 2013.

⁴ Cox, Christopher, “[Letter to Basel Committee Re Sound Practices for Managing Liquidity In Banking Organizations](#)”, Securities and Exchange Commission, March 20, 2008.

the year, Lehman Brothers and other major banks experienced similar rapid collapses in liquidity. It is therefore vital to require that banks provision for peak liquidity demands. We strongly support this element of the rule.

Another important way in which this proposal is strengthened compared to the Basel proposal is the more restricted list of assets which qualify for inclusion in the liquidity reserve. The categorical exclusion of covered bonds and all instruments issued by regulated financial companies (banks, insurance companies, and broker-dealers) or similar entities is a very positive step. As the Agencies correctly note, such assets are subject to wrong-way risk (they are likely to lose value at precisely the moment banks come under stress). The Basel LCR permits some assets issued by financial entities to qualify as Level II assets; the Agencies were correct to reject this. Another positive element of the U.S. rule as compared to the Basel Rule is the exclusion of securitizations such as mortgage backed securities from Level II liquid assets.

The proposal also reflects a thoughtful analysis of potential funding issues in several areas. Some of the especially important ones are:

Prime Brokerage: During the financial crisis, prime brokerage funding proved some of the most vulnerable type of funding to runs. For example, Morgan Stanley lost almost half of its total liquidity reserves in just ten days in September 2008, and two-thirds of this liquidity runoff was due to losses in prime brokerage funding.⁵ The Agencies correctly classify prime brokerage funds as unsecured wholesale funds with a 100% runoff rate, rather than as operational deposits with a lower runoff rate. The 100% runoff rate for prime brokerage funds must be preserved in the final rule. In the next section we also call for the Agencies to specify a broad definition of prime brokerage services to ensure that this restriction is not arbitrated.

Encumbered Funds: The Agencies correctly require that all resources in the liquidity reserve be unencumbered. Famously, some 95 percent of resources in what Lehman Brothers advertised to investors as its ‘liquidity pool’ were encumbered in some way and thus not readily monetizable.⁶ Unless the requirement that resources be unencumbered is fully maintained and strictly enforced, the LCR rule will not be effective in creating a functional liquidity buffer. While the requirement in the Proposed Rule is clearly stated it remains very broad. Agencies should specify that, for example, all borrowed assets are treated as encumbered.

Collateral Outflows and Valuation Changes: Margin calls triggered by ratings downgrades or other changes in market perception of a company’s financial condition can be a major source of liquidity shocks. The Agencies correctly require that banks count possible collateral outflows due to changes in financial condition as part of the stressed liquidity scenario. The Agencies also require a 20 percent provision for changes in collateral value due to market stress. These are both very valuable components of the Proposed Rule and should not be weakened.

The above do not exhaust the strengths of the Proposed Rule – the careful attention to the operational issues involved in monetizing the liquidity reserve, including the accessibility of

⁵ See p. 7, Duffie, Darrell, “[Liquidity And Stress Testing](#)”, Presentation at the Financial Advisory Round Table, Federal Reserve Bank of NY, June 8, 2012.

⁶ Valukas report

liquidity resources in foreign affiliates, is also worthy of note – but they represent several key areas where it is important that strengths in the Proposed Rule be maintained in the final rule.

Weaknesses of the Proposed Rule And Issues Calling for Further Examination

The Agencies have chosen to follow the lead of the Basel Committee in permitting a significant minority of the liquidity reserve to be held in the form of assets that are not cash reserves with the central bank or direct sovereign obligations. This is apparently due to the concern that there may be a shortage of high quality liquid assets. As discussed in the introduction, this concern does not seem valid given the global supply of liquid assets and the ability to provide additional fee-based liquidity.

The reliance for liquidity purposes on a wider range of assets raises many complex issues around the reliability of asset values during a crisis. The Agencies do provide a thoughtful discussion of the issues here, and correctly require that non-cash liquid assets be simple, standardized, transparent, and where possible exchange-traded. The rule also requires significant haircuts on corporate debt and equities. However, these complexities could be avoided by simply increasing the reliance on cash reserves or U.S. Treasuries.

A related and important issue here is the blanket inclusion of all sovereign obligations with a zero capital risk weight in Level 1 liquid assets. Due to the very broad range of sovereign debt receiving a zero risk weight under the Basel Rules, this list is likely to include many sovereign entities whose commitments could pose credit, liquidity, or exchange rate risk. The Agencies make note of an additional requirement to demonstrate that the value of sovereign debt has not fluctuated significantly in past stress periods, but past periods may not reflect potential future threats. The Agencies should reexamine this issue.

However, if the Agencies do decide to continue the reliance on such instruments as corporate debt, equities, and a very broad range of sovereign obligations in the Final Rule, they should reconsider the blanket exclusion of all municipal debt and obligations from the liquidity buffer. It is clear that from a pure credit risk perspective, many municipal obligations hold value better than corporate debt, certainly equities, and possibly some foreign sovereign obligations that are exposed to exchange rate risk. The Agencies correctly note that there are potential liquidity issues with municipal debt. However, such liquidity issues would not impact all municipal obligations equally. It seems highly likely that there is a subset of municipal debt – for example, simple general obligation bonds from recognized issuers – which has comparable liquidity the investment grade corporate debt permitted under this proposal. The Agencies should reexamine this issue.

There are also several issues in the outflow and inflow rates assumed under this proposal:

Outflow rates for liquidity facilities: The proposal assumes a 30 percent outflow rate for committed liquidity facilities to non-financial companies, and a 50 percent outflow rate for committed liquidity facilities for depository institutions. Most of these committed liquidity facilities are likely to be for commercial paper issuance. It seems highly unlikely that either non-financial companies or depository institutions will be able to turn over 50 to 70 percent of their

commercial paper funding during a financial crisis. During the 2008 crisis, commercial paper markets came under severe strain even though there was massive liquidity support provided through Federal Reserve facilities. Other instruments dependent on liquidity facilities, such as Auction Rate Securities, also collapsed. These outflow rates should be raised significantly, possibly to the 100 percent level for committed liquidity facilities for non-depository financial institutions.

Outflow rates for derivatives commitments: The Proposed Rule specifies outflow rates for derivatives commitments as the sum of collateral and payments due over the next 30 days, with netting permitted in cases where there is a qualified master netting agreement. Derivatives valuations will obviously depend on projected valuation changes over the 30 day period, and the Agencies note that these should be calculated in accordance with ‘existing valuation methodologies’. However, there is no mention of any calculation of derivatives outflow rates under stressed conditions. Agencies should require derivatives outflow rates to be calculated under a stressed scenario, including the possibility of some rehypothecation of previously netted transactions. Such unexpected rehypothecation was a major source of stress during the financial crisis.⁷

Cash inflows and income stresses: It is unclear how the Proposed Rule treats fee income under cash inflows. Unless fee income is included under wholesale payments, there appears to be no provision for or discussion of the possibility that fee income will greatly decline during a situation of market stress. It seems likely that any fee income that is directly tied to either the volume of market transactions or the level of asset valuations will come under significant pressure during a market stress period. This should be reflected in the inflow assumptions.

Prime brokerage definition: As discussed above, the Agencies correctly assume a 100% outflow rate for prime brokerage funding. We believe this is entirely appropriate and should be maintained. However, the similarity of prime brokerage funding to some types of operational funding raise some issues around the definition of and possible relabeling of prime brokerage transactions. The Agencies should give a broad definition of prime brokerage in the final rule, to include bundled master account services provided for professional investment entities. Such entities should include professional investment services performed for non-bank and non-dealer companies, such as insurance companies and sophisticated corporate treasury functions that invest to maximize return.

Membership in Clearing Houses: As a member of a clearing house, a bank may be called upon to make a sudden and significant default fund contribution due to the failure of another clearing member. While this is reflected to some degree in capital requirements, given the importance of the issue to the financial system, the Agencies should carefully consider whether it should be reflected in liquidity reserves.

The LCR also raises several broader issues related to liquidity risk and financial regulation. Some of these issues may be more fully addressed in other rules, but we will mention them quickly here.

⁷ Duffie, Darryl, How Big Banks Fail and What To Do About It, Princeton University Press, 2011.

Timing of liquidity demands: This Proposed Rule is obviously vulnerable to arbitrage through products that keep liquidity demands just outside of the 30 day liquidity window (for example, a repo with a term greater than 30 days that is regularly rolled over 31 days prior to becoming due, or a deposit with a 31 day call option). The Net Stable Funding Ratio should address these issues, so they may be temporary. There is also some value to extending liquidity demands beyond the 30 day window. However, supervisors should be attentive to the possibility that excessive liquidity demands build up just outside the 30 day window.

Liquidity and counter-cyclical prudential regulation: Liquidity requirements have a more direct impact on lending capacity than capital requirements do, as they require banks to maintain a reserve of highly liquid non-loan assets, while capital requirements simply affect liabilities and have no direct effect on asset composition. However, precisely for this reason liquidity regulations may be a more effective counter-cyclical tool than capital regulation. This Proposed Rule already includes some counter-cyclical component, as it correctly permits banks to draw down liquidity reserves during stressed periods. But the Agencies should consider making greater use of the counter-cyclical potential of liquidity regulation by permitting liquidity requirements to be adjusted upward during periods where markets are overheated, similarly to the counter-cyclical capital requirements under Basel. This mechanism could work either through the LCR or one of the other liquidity-related rules under consideration.

Finally, we wish to make a comment regarding the cost-benefit discussion beginning on CFR 71853 of the Proposed Rule. This discussion appears to count as a social cost the small amount of lost yield to banks due to the holding of additional high quality liquid assets instead of riskier and less liquid assets. However, this lost yield would primarily be a private cost to the bank, not a social cost. The riskier assets do not disappear from the financial system, they move outside of the banking sector. Their returns will continue to be earned there (and should in fact be higher since banks will not be bidding for them). A cost benefit analysis should be a general equilibrium analysis that counts social costs only and offsets transfers between private parties (unless equity concerns come into play). The confusion of private and social costs has been common in discussions of financial regulation but the Agencies should avoid it.

Thank you for the opportunity to comment on this Proposed Rule. Should you have any questions, please contact Marcus Stanley, AFR's Policy Director, at 202-466-3672 or marcus@ourfinancialsecurity.org.

Following are the partners of Americans for Financial Reform.

All the organizations support the overall principles of AFR and are working for an accountable, fair and secure financial system. Not all of these organizations work on all of the issues covered by the coalition or have signed on to every statement.

- AARP
- A New Way Forward
- AFL-CIO
- AFSCME
- Alliance For Justice
- American Income Life Insurance
- American Sustainable Business Council
- Americans for Democratic Action, Inc
- Americans United for Change
- Campaign for America's Future
- Campaign Money
- Center for Digital Democracy
- Center for Economic and Policy Research
- Center for Economic Progress
- Center for Media and Democracy
- Center for Responsible Lending
- Center for Justice and Democracy
- Center of Concern
- Center for Effective Government
- Change to Win
- Clean Yield Asset Management
- Coastal Enterprises Inc.
- Color of Change
- Common Cause
- Communications Workers of America
- Community Development Transportation Lending Services
- Consumer Action
- Consumer Association Council
- Consumers for Auto Safety and Reliability
- Consumer Federation of America
- Consumer Watchdog
- Consumers Union
- Corporation for Enterprise Development
- CREDO Mobile
- CTW Investment Group
- Demos
- Economic Policy Institute
- Essential Action
- Green America

- Greenlining Institute
- Good Business International
- HNMA Funding Company
- Home Actions
- Housing Counseling Services
- Home Defender's League
- Information Press
- Institute for Agriculture and Trade Policy
- Institute for Global Communications
- Institute for Policy Studies: Global Economy Project
- International Brotherhood of Teamsters
- Institute of Women's Policy Research
- Krull & Company
- Laborers' International Union of North America
- Lawyers' Committee for Civil Rights Under Law
- Main Street Alliance
- Move On
- NAACP
- NASCAT
- National Association of Consumer Advocates
- National Association of Neighborhoods
- National Community Reinvestment Coalition
- National Consumer Law Center (on behalf of its low-income clients)
- National Consumers League
- National Council of La Raza
- National Council of Women's Organizations
- National Fair Housing Alliance
- National Federation of Community Development Credit Unions
- National Housing Resource Center
- National Housing Trust
- National Housing Trust Community Development Fund
- National NeighborWorks Association
- National Nurses United
- National People's Action
- National Urban League
- Next Step
- OpenTheGovernment.org
- Opportunity Finance Network
- Partners for the Common Good
- PICO National Network
- Progress Now Action
- Progressive States Network
- Poverty and Race Research Action Council

- Public Citizen
- Sargent Shriver Center on Poverty Law
- SEIU
- State Voices
- Taxpayer's for Common Sense
- The Association for Housing and Neighborhood Development
- The Fuel Savers Club
- The Leadership Conference on Civil and Human Rights
- The Seminal
- TICAS
- U.S. Public Interest Research Group
- UNITE HERE
- United Food and Commercial Workers
- United States Student Association
- USAction
- Veris Wealth Partners
- Western States Center
- We the People Now
- Woodstock Institute
- World Privacy Forum
- UNET
- Union Plus
- Unitarian Universalist for a Just Economic Community

List of State and Local Partners

- Alaska PIRG
- Arizona PIRG
- Arizona Advocacy Network
- Arizonans For Responsible Lending
- Association for Neighborhood and Housing Development NY
- Audubon Partnership for Economic Development LDC, New York NY
- BAC Funding Consortium Inc., Miami FL
- Beech Capital Venture Corporation, Philadelphia PA
- California PIRG
- California Reinvestment Coalition
- Century Housing Corporation, Culver City CA
- CHANGER NY
- Chautauqua Home Rehabilitation and Improvement Corporation (NY)
- Chicago Community Loan Fund, Chicago IL
- Chicago Community Ventures, Chicago IL
- Chicago Consumer Coalition
- Citizen Potawatomi CDC, Shawnee OK
- Colorado PIRG

- Coalition on Homeless Housing in Ohio
- Community Capital Fund, Bridgeport CT
- Community Capital of Maryland, Baltimore MD
- Community Development Financial Institution of the Tohono O'odham Nation, Sells AZ
- Community Redevelopment Loan and Investment Fund, Atlanta GA
- Community Reinvestment Association of North Carolina
- Community Resource Group, Fayetteville A
- Connecticut PIRG
- Consumer Assistance Council
- Cooper Square Committee (NYC)
- Cooperative Fund of New England, Wilmington NC
- Corporacion de Desarrollo Economico de Ceiba, Ceiba PR
- Delta Foundation, Inc., Greenville MS
- Economic Opportunity Fund (EOF), Philadelphia PA
- Empire Justice Center NY
- Empowering and Strengthening Ohio's People (ESOP), Cleveland OH
- Enterprises, Inc., Berea KY
- Fair Housing Contact Service OH
- Federation of Appalachian Housing
- Fitness and Praise Youth Development, Inc., Baton Rouge LA
- Florida Consumer Action Network
- Florida PIRG
- Funding Partners for Housing Solutions, Ft. Collins CO
- Georgia PIRG
- Grow Iowa Foundation, Greenfield IA
- Homewise, Inc., Santa Fe NM
- Idaho Nevada CDFI, Pocatello ID
- Idaho Chapter, National Association of Social Workers
- Illinois PIRG
- Impact Capital, Seattle WA
- Indiana PIRG
- Iowa PIRG
- Iowa Citizens for Community Improvement
- JobStart Chautauqua, Inc., Mayville NY
- La Casa Federal Credit Union, Newark NJ
- Low Income Investment Fund, San Francisco CA
- Long Island Housing Services NY
- MaineStream Finance, Bangor ME
- Maryland PIRG
- Massachusetts Consumers' Coalition
- MASSPIRG
- Massachusetts Fair Housing Center
- Michigan PIRG

- Midland Community Development Corporation, Midland TX
- Midwest Minnesota Community Development Corporation, Detroit Lakes MN
- Mile High Community Loan Fund, Denver CO
- Missouri PIRG
- Mortgage Recovery Service Center of L.A.
- Montana Community Development Corporation, Missoula MT
- Montana PIRG
- Neighborhood Economic Development Advocacy Project
- New Hampshire PIRG
- New Jersey Community Capital, Trenton NJ
- New Jersey Citizen Action
- New Jersey PIRG
- New Mexico PIRG
- New York PIRG
- New York City Aids Housing Network
- New Yorkers for Responsible Lending
- NOAH Community Development Fund, Inc., Boston MA
- Nonprofit Finance Fund, New York NY
- Nonprofits Assistance Fund, Minneapolis M
- North Carolina PIRG
- Northside Community Development Fund, Pittsburgh PA
- Ohio Capital Corporation for Housing, Columbus OH
- Ohio PIRG
- OligarchyUSA
- Oregon State PIRG
- Our Oregon
- PennPIRG
- Piedmont Housing Alliance, Charlottesville VA
- Michigan PIRG
- Rocky Mountain Peace and Justice Center, CO
- Rhode Island PIRG
- Rural Community Assistance Corporation, West Sacramento CA
- Rural Organizing Project OR
- San Francisco Municipal Transportation Authority
- Seattle Economic Development Fund
- Community Capital Development
- TexPIRG
- The Fair Housing Council of Central New York
- The Loan Fund, Albuquerque NM
- Third Reconstruction Institute NC
- Vermont PIRG
- Village Capital Corporation, Cleveland OH
- Virginia Citizens Consumer Council

- Virginia Poverty Law Center
- War on Poverty - Florida
- WashPIRG
- Westchester Residential Opportunities Inc.
- Wigamig Owners Loan Fund, Inc., Lac du Flambeau WI
- WISPIRG

Small Businesses

- Blu
- Bowden-Gill Environmental
- Community MedPAC
- Diversified Environmental Planning
- Hayden & Craig, PLLC
- Mid City Animal Hospital, Pheonix AZ
- UNET