

January 31, 2014

Office of the Comptroller of the Currency  
400 7<sup>th</sup> Street, S.W., Suite 3E-218  
Mail Stop 9W-11  
Washington, D.C. 20219  
Attention: Legislative and Regulatory Activities  
Division  
**Docket ID OCC-2013-0016**  
**RIN 1557 AD 74**

Board of Governors of the Federal Reserve  
System  
20<sup>th</sup> Street & Constitution Avenue, N.W.  
Washington, D.C. 20551  
Attention: Robert de V. Frierson, Secretary  
**Docket No. R-1466**  
**RIN 7100-AE03**

Federal Deposit Insurance Corporation  
550 17<sup>th</sup> Street, N.W.  
Washington, D.C. 20429  
Attention: Robert E. Feldman, Executive  
Secretary  
**RIN 3064-AE04**

Re: Liquidity Coverage Ratio: Liquidity Risk Measurement, Standards, and Monitoring

Ladies and Gentlemen:

This comment letter is submitted in response to the Notice of Proposed Rulemaking jointly proposed by the Office of the Comptroller of the Currency (“OCC”), the Board of Governors of the Federal Reserve System (“FRB”), and the Federal Deposit Insurance Corporation (“FDIC” and, collectively, the “Agencies”) entitled *Liquidity Coverage Ratio: Liquidity Risk Measurement, Standards, and Monitoring* (the “Proposed LCR Rule” or “NPR”).<sup>1</sup> The Proposed LCR Rule generally would implement in the United States the international liquidity standards (“International Liquidity Standards”) published by the Basel Committee on Banking Supervision (“Basel Committee”).<sup>2</sup>

On behalf of Wells Fargo & Company (“Wells Fargo” or “We”) and its national banking association subsidiaries, including Wells Fargo Bank, National Association, we appreciate the opportunity to provide comments on the Proposed LCR Rule. Wells Fargo supports the implementation of an LCR requirement in the United States that is generally consistent with the International Liquidity Standards. While there may be instances where deviation because of

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<sup>1</sup> 78 Fed. Reg. 71818 (Nov. 29, 2013).

<sup>2</sup> The Basel Committee published the international liquidity standards in December 2010 (*Basel III: International framework for liquidity risk measurement, standards and monitoring* (December 2010)) (“Proposed Basel LCR”) and revised the standards in January 2013 (*Basel III: The Liquidity Coverage Ratio and liquidity risk monitoring tools* (January 2013)).

uniqueness in U.S. markets or regulatory structure is called for, we are concerned that the Proposed LCR Rule deviates significantly from the International Liquidity Standards in ways that are not necessarily empirically based, interfere with the goals of comparability across jurisdictions, and result in numerous unintended consequences.

The purpose of our comment letter is to highlight some of our specific concerns and to propose solutions that we believe will allow the LCR to function more effectively without unneeded disruption to markets. In addition, we offer some of the empirical experience of our predecessor firm Wachovia Corporation (“Wachovia”) and Wachovia Bank, National Association (“Wachovia Bank”) which did experience some liquidity challenges during the height of the financial crisis in the fall of 2008 before the combination of Wachovia and Wells Fargo. Our letter is divided into three main sections. Section I addresses issues regarding total net outflow; section II addresses certain issues related to qualification of an asset as a high-quality liquid asset (“HQLA”); and section III addresses the supervisory response to an LCR shortfall.

In the course of preparing this comment letter Wells Fargo has worked closely with a number of trade organizations, including the Clearing House Association L.L.C., the American Bankers Association, Securities Industry and Financial Markets Association, the Financial Services Round Table, the Institute of International Bankers, and the Structured Finance Industry Group (collectively, the “Associations”), in connection with their joint comment letter regarding the Proposed LCR Rule (the “Joint Trade Association LCR Letter”). Although we are filing this comment letter to highlight areas of particular concern to us, or where we believe we have relevant specific data to share, we generally support the Joint Trade Association LCR Letter, share the concerns that letter raises and generally endorse the suggestions made in the Joint Trade Association LCR Letter.

## **I. Comments Pertaining to Total Net Cash Outflow**

### **Treatment of Municipal and Other Collateralized Deposits<sup>3</sup>**

*Collateralized deposits do not behave like secured financing transactions and should not flow through the LCR cap calculation.*

The Proposed LCR Rule classifies the collateralized deposits of U.S. municipalities and public sector entities as “secured funding transactions” under § \_\_.3. This designation causes the deposits to have no liquidity value: i.e. every \$1 of deposits taken requires a Bank to hold \$1 in either cash or U.S. Treasury Securities. Holding 100% liquidity reserves for these deposits does not reflect the behavior observed during Wachovia’s liquidity crises in 2008, where we saw the largest monthly decline in collateralized municipal deposit balances of 11% after the bankruptcy of Lehman Brothers.

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<sup>3</sup> This section is in response to Questions 49 and 54 within the NPR as it pertains to collateralized deposits.

Moreover, requiring liquidity reserves equivalent to 100% of the deposit creates a strong incentive for Banks to stop offering collateralized deposits to public sector customers: they create little or no net interest income, attract FDIC insurance costs (even though fully collateralized), put pressure on leverage ratios, and consume operational risk capital.

Municipalities and public sector entities consider collateralized bank deposits a convenient and safe product for operating funds as well as excess funds. Without ready and cost effective access to depository services to manage their funds, they could have substantial practical difficulties in managing tax receipts and disbursing day-to-day expenses in the provision of public services to their citizens. We firmly believe this cannot have been an intended consequence of the U.S. Proposal.

Once designated as a “secured funding transaction,” municipal deposits come under an LCR cap calculation mechanism that requires an assumed “unwind.” In this calculation, 100% of the deposits are assumed to run, decreasing HQLA by the amount of the deposit. This process effectively “traps” the cash generated by the deposit, as it must be held as an HQLA asset to provide for the assumed “unwind” else the bank’s HQLA will decline, negatively impacting the LCR. This problem is especially acute for banks that are over the cap on Agency MBS, because for those institutions, the only HQLA categories available are cash and US Treasury Securities.

Many municipal deposits are collateralized by Agency MBS – at Wells Fargo, approximately 85% of our collateralized deposits are backed by Agency MBS. It has been suggested that to eliminate the impact of the cap, banks could collateralize municipal deposits with U.S. Treasuries instead of Agency MBS. This would require a structural change in bank balance sheets: as of 9/30/13, the top 3 municipal depositories in the U.S. (WFC, JPM, and BAC), held \$109.5 billion in municipal deposits, but only \$20.7 billion in U.S. Treasury Securities in their AFS and HTM accounts.<sup>4</sup> This demonstrates the preference banks have for deploying stable municipal deposits funds into higher yielding loans and securities. If the cap and unwind rules were to be implemented as proposed, the reduction in profitability arising from a required redeployment to lower yielding U.S. Treasuries would increase the incentive for banks to stop offering collateralized municipal deposits.

The stated purpose of the unwind convention is “to prevent a covered company from having a substantial amount of transactions that would create the appearance of a significant Level 1 liquid asset amount at the beginning of the 30-day stress period, but would unwind by the end of the 30-day stress period.”<sup>5</sup> While we acknowledge that there may be transactions and arrangements which could give rise to this issue, collateralized deposits of U.S. municipalities and public sector entities are significantly different in nature than other types of secured funding transactions where banks, at their discretion, seek funding to finance their securities inventory in the wholesale funding markets.

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<sup>4</sup> Based on data available from SNL Financial LC and the FDIC’s online Institution Directory for Bank Holding Companies.

<sup>5</sup> NPR at page 71832.

As recognized in the Federal Deposit Insurance Act (the “FDIA”),<sup>6</sup> the laws of various states require that the deposits of certain municipalities and other public sector entities must be “secured or collateralized” by the insured depository institution which holds such deposits. The amount of such deposits in the U.S. is significant, totaling approximately \$443.6 billion as of September 2013.<sup>7</sup> These types of secured deposit arrangements are a critically important component of the overall relationship among the banking industry and public sector entities and the broad suite of banking products provided by the banking industry to these important customers.

Given the major differences between municipal deposits, on the one hand, and more traditional securities financing transactions, on the other hand, we do not believe these deposits pose the HQLA overstatement risks identified by the U.S. Proposal. It is exceedingly difficult to accept that a bank would deliberately attempt to raise greater amounts of municipal deposits in an effort to increase the amount of higher quality HQLA on its balance sheet for LCR purposes. To the extent the Agencies have concern regarding such manipulation, they could be more than adequately dealt with through the supervisory and examination process.

Accordingly, we request that the Agencies exclude collateralized deposits from U.S. municipalities and public sector entities from the unwind requirement of Section 21(f) in the final U.S. LCR.

In addition, the Proposed LCR Rule does not properly rank order the risks of deposits backed by non-HQLA. This is due to the fact that the Proposed LCR Rule assigns a 100% outflow rate to these collateralized deposits under the secured funding transaction classification, analogous to a high risk unsecured overnight deposit. In no scenario should a collateralized deposit have a higher prescribed outflow rate than an equivalent unsecured deposit from the same counterparty. For example, an operational Corporate Trust deposit collateralized by non-HQLA and deposited by a Non-Financial Corporate counterparty would be assigned a 100% outflow rate, while an unsecured operational Corporate Trust deposit with the same counterparty that was over the FDIC insurance limit would be assigned a 25% outflow rate. Therefore, we suggest that collateralized deposits backed by non-HQLA should, at worst, be treated as unsecured deposits and be subject to the operational deposit tests instead of being prescribed a 100% outflow factor.

### **Outflow Rates of Affiliate and Non-Affiliate Brokered Sweep Deposits<sup>8</sup>**

*The proposed outflow rates for brokered deposits are not empirically based and consequently should be decreased.*

Under the Proposed LCR Rule, brokered sweep deposits are assigned progressively higher outflow rates depending on the level of insurance coverage and the affiliation of the broker

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<sup>6</sup> See 18 U.S.C. 1831(m)(4).

<sup>7</sup> Based on data available from SNL Financial LC.

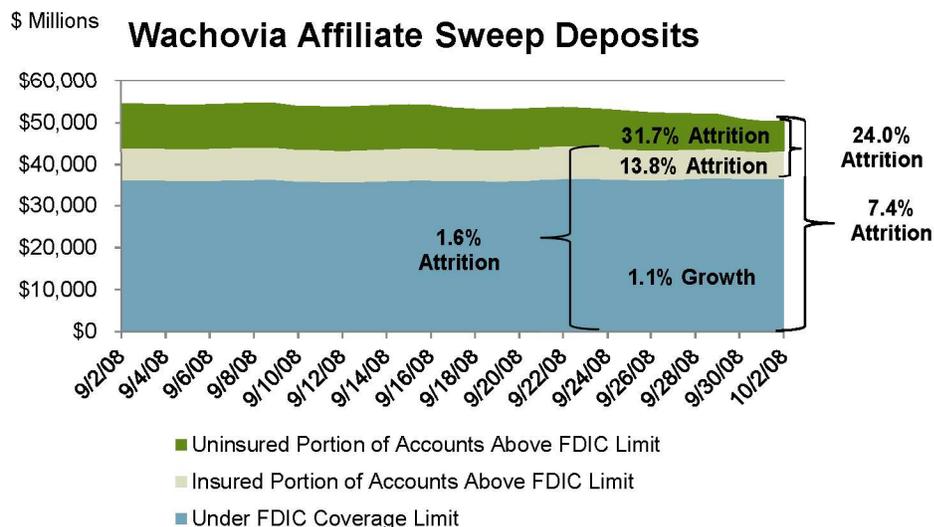
<sup>8</sup> This section is in response to Questions 47 and 48 within the NPR.

sweeping the deposit to the bank. Brokered sweep deposits from an affiliate that are entirely covered by deposit insurance are prescribed a 10% outflow rate, while non-affiliate brokered sweep deposits that are entirely covered by deposit insurance are prescribed a 25% outflow rate. Affiliate and non-affiliate brokered sweep deposits that are not entirely covered by deposit insurance are prescribed a 40% outflow rate. The Agencies assigned a greater outflow rate to deposits that are not fully insured due to the fact that “they have been observed to be more volatile during stress periods, as customers seek alternative investment vehicles or use those funds for other purposes.”<sup>9</sup>

We recognize that the brokerage sweep deposit market is unique to the United States and believe that the Agencies have appropriately determined that separate outflow factors are necessary. We further agree that a “look through” approach is appropriate for brokerage sweep deposits in recognition of the fact that the primary decision maker on the deposits is the retail or small business customer as reflected in the December 2012 QIS U.S. Cover Note. However, we feel that the proposed categorization and prescribed outflow rates should be adjusted based on historical attrition data.

Our data, based upon legacy Wachovia observations, leads us to agree that brokered sweep deposits that are not fully insured experience elevated attrition compared to fully insured accounts. However, the historical experience of both of Wachovia’s brokered sweep deposit programs; the affiliated brokered sweep deposit program offered through Wachovia Securities and the non-affiliated single bank brokered sweep deposit program offered through First Clearing, during the recent financial crisis support lower prescribed outflow rates than those proposed by the Agencies.<sup>10</sup>

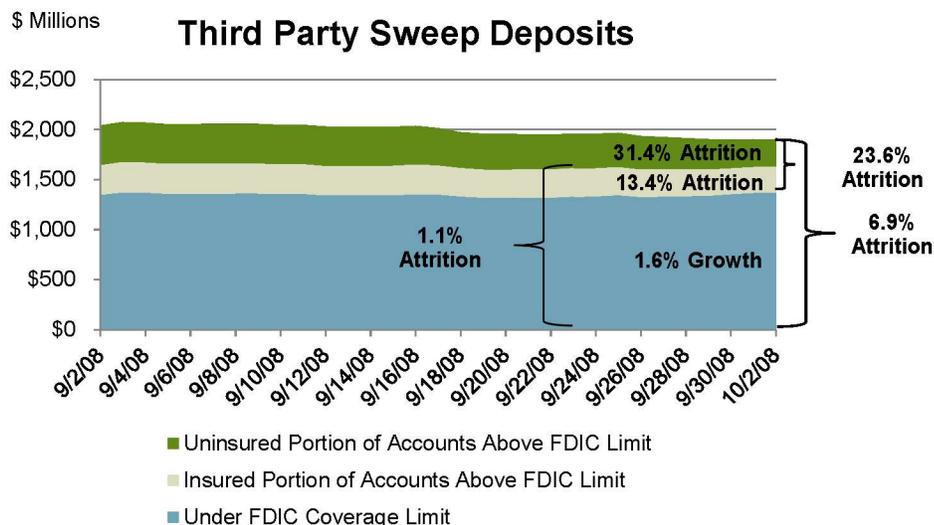
**Figure 1: Wachovia Affiliate Sweep Deposit Attrition**



<sup>9</sup> NPR at page 71840.

<sup>10</sup> The 30 days ending October 2, 2008 represents the peak 30-day deposit attrition experienced in Wachovia’s sweep deposit programs.

**Figure 2: Wachovia Non-Affiliate Sweep Deposit Attrition**



The attrition data in the previous figures confirm the Agencies’ view that deposits that are fully covered by insurance are materially less volatile during stressful periods. The data also confirm that historical attrition rates are notably lower than the proposed outflow rates. In aggregate, Wachovia’s sweep deposit program was one of the most stable deposit products across the firm, with only approximately 7% attrition. Based on the definition of insured deposits in the Proposed LCR Rule, fully insured deposits of both affiliated and third party sweep programs actually increased during stress, while the deposits that are not fully insured experienced just less than 25% attrition. The Wachovia attrition data also shows that the attrition rates for the First Clearing third party brokered sweep deposits were substantially the same as the affiliate brokered sweep deposits.<sup>11</sup> We believe the virtually identical deposit performance during a stressful period is primarily due to the structure of the First Clearing program, whereby Wachovia was the only option.

We believe the Wachovia historical data represents the most relevant experience involving a bank with a large brokered sweep deposit program facing significant liquidity degradation during severe market stress, and we recommend the prescribed runoff rates be adjusted as follows:

- Affiliate brokered sweep customers whose accounts are fully insured and who have multiple relationships with the bank are unlikely to withdraw their deposit and should be treated similar to a Stable Retail Deposit, just as any of their other deposit relationships managed within retail banking would. As such, their deposit would be prescribed a 3% outflow rate.

<sup>11</sup> Wachovia Corporation was the ultimate parent of First Clearing; however, the introducing broker dealers who cleared with First Clearing were unaffiliated with Wachovia.

- Other fully insured non-affiliate sweep deposits should be prescribed 10% outflow rate, similar to a Retail Less Than Stable deposit.
- Affiliate and non-affiliate single bank brokered sweep deposits (i.e. not part of a multi-bank sweep program) that are not entirely covered by deposit insurance should be prescribed a 25% outflow rate.
- Non-affiliate brokered sweep deposits that are offered as part of a multi-bank sweep program and are not entirely covered by deposit insurance should be prescribed a 40% outflow rate.

**Figure 3: Wells Fargo Suggested Brokered Sweep Deposit Outflow Rates vs. Outflow Rates Under the Proposed LCR Rule**

	Observed		Proposed LCR Rule		Wells Fargo Proposal	
	Fully Insured	Not Fully Insured	Fully Insured	Not Fully Insured	Fully Insured	Not Fully Insured
Affiliated	1.1%	-24.0%	-10.0%	-40.0%	-3.0%	-25.0%
Non-Affiliated Single Bank	1.6%	-23.6%	-25.0%	-40.0%	-10.0%	-25.0%
Non-Affiliated Multibank Platform	N/A	N/A	-25.0%	-40.0%	-10.0%	-40.0%

These suggested outflow rates are based on empirical evidence while also taking into consideration the insured status of the account, the potential influence of third parties (i.e. introducing broker dealers), and the level of difficulty the retail customer would face to move their deposits to another bank within 30 days.

**Insured Definition for Operational Deposits<sup>12</sup>**

*The insured definition for operational deposits should revert to the Basel definition and therefore include both fully insured accounts and the insured portions of accounts that in total are over the FDIC insurance limits.*

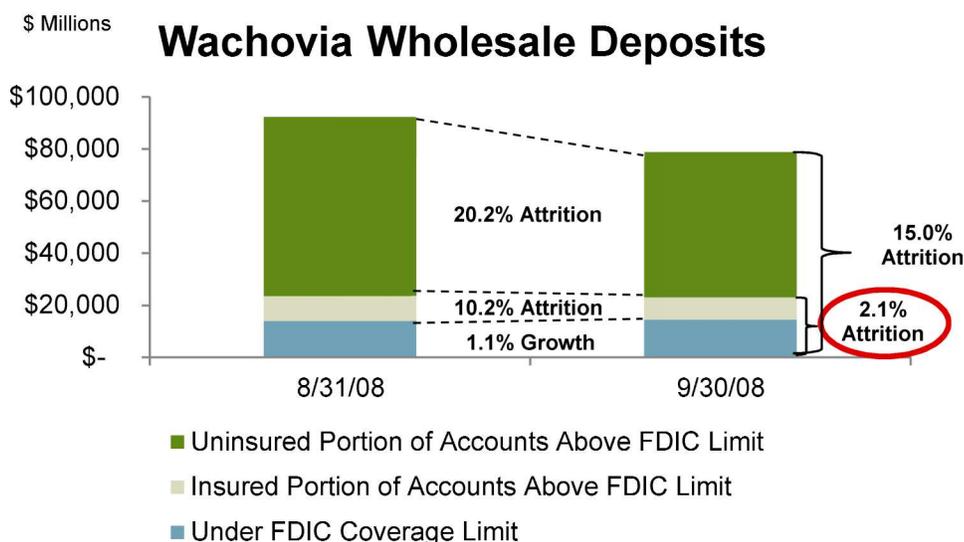
In the International Liquidity Standards and subsequent FAQ clarifications published by the Basel Committee, both accounts fully covered by deposit insurance as well as the insured portions of accounts that are greater than the deposit insurance limits are both considered insured. The insured portions of operational deposits would then qualify for a 5% outflow rate. However, under the Proposed LCR Rule, the 5% outflow rate is only assigned to accounts where the entire deposit amount is fully covered by deposit insurance. Partially insured and uninsured deposits are treated as uninsured and assigned a 25% outflow rate.

While wholesale deposits that are not fully insured experience elevated attrition compared to fully insured accounts, the historical experience of Wachovia’s wholesale deposits during the

<sup>12</sup> This section is in response to Question 49 within the NPR as it pertains to the insured portion of operational deposits.

recent financial crisis support the Basel definition of lower prescribed outflow rates than those proposed by the Agencies.<sup>13</sup> As seen in the figure below, Wachovia’s insured wholesale balances decreased only ~2% during a 30-day stress period including the Lehman bankruptcy. This 2% average attrition rate included the insured portion of accounts above the FDIC limit as well as both operational and non-operational deposit accounts.

**Figure 4: Wachovia Wholesale Deposit Attrition**



Given this low observed combined attrition rate (both operational and non-operational insured accounts), the International Liquidity Standards’ prescribed outflow rate of 5% on all insured operational balances appears reasonable, if not conservative. Requiring a 25% runoff rate on the insured portion of operational accounts that exceed the FDIC limit (as the US LCR proposal does) is not supported by empirical evidence.

Given the absence of inherent differences in U.S. vs. International operational deposits and the empirical evidence that supports the International Liquidity Standards’ prescribed 5% outflow rate for the combined population of accounts where the entire amount is covered by deposit insurance and the insured portions of accounts that are greater than the deposit insurance limits, we believe the insured definition for operational accounts should revert to the International Liquidity Standards’ definition.

<sup>13</sup> The month of September 2008 represents the peak monthly deposit attrition experienced in Wachovia’s wholesale deposits.

## **Definition of SPEs for Credit Facilities<sup>14</sup>**

*The current SPE definition is over-inclusive and should be updated to properly reflect the types of entities that are likely to experience liquidity stress during a financial crisis.*

Under the Proposed LCR Rule, credit and liquidity facilities made to special purpose entities (“SPEs”) are prescribed a 100% outflow rate. The Agencies appear concerned about SPEs’ sensitivity to emergency cash needs during a short-term liquidity stress environment, which could lead to draws on backstop facilities. In fact, the Agencies stated that during the recent financial crisis, “many SPEs experienced severe cash shortfalls, as they could not rollover debt and had to rely on borrowing and backstop lines.”<sup>15</sup> While the Agencies appear to focus their concern on SPEs’ inability to roll short-term market based funding, the proposed definition of an SPE is overly broad and does not attempt to incorporate market based funding risks. A Special Purpose Entity is defined in the Proposed LCR Rule as “a company organized for a specific purpose, the activities of which are significantly limited to those appropriate to accomplish a specific purpose, and the structure of which is intended to isolate the credit risk of the special purpose entity.”<sup>16</sup> This definition is over-inclusive and does not attempt to differentiate between SPEs that rely on short-term market based funding and those SPEs that were created simply to isolate the credit risk of the borrower’s parent by the SPE acting as the borrower under an arrangement to fund a pool of designated assets owned by the corporate parent. For example, a committed facility backstopping a structured investment vehicle’s (“SIV”) commercial paper program has a materially higher liquidity risk than a committed credit facility to an SPE subsidiary of an automobile loan originator with no direct short term market issuance.

We agree that facilities with a primary purpose to serve as a backstop for short-term market based funding should receive higher prescribed outflow rates than traditional credit facilities. However, a large number of facilities to SPEs do not serve as a backstop for short-term market based funding, but instead are substantially similar to traditional credit facilities. They are often originated as a substitute for or in addition to traditional revolving credit facilities. Unsecured revolving credit facilities, secured revolving credit facilities to non-SPEs, and secured revolving credit facilities to SPEs should all be considered credit facilities when they are not backstopping short-term market based funding. The likelihood of a draw of secured revolving credit facilities to SPEs is no higher than other traditional secured and unsecured credit facilities and is lower than a liquidity facility given the fact that borrowing decisions are driven primarily by customers’ business related borrowing needs, not the need to payoff short-term funding that is unable to be rolled in the market. In fact, all else being equal, a company would likely draw down the unused capacity of an unsecured credit facility during the early signs of a potential market liquidity stress prior to drawing on a secured facility to an SPE knowing that in the depths of a crisis, its lenders will be more comfortable continuing to lend to the SPE with its

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<sup>14</sup> This section is in response to Questions 42 and 43 within the NPR as it relates to SPEs.

<sup>15</sup> NPR at page 71838.

<sup>16</sup> Proposed LCR Rule in § \_\_.3.

credit enhancement. Industry draw rates on secured credit facilities provided to SPEs experienced no significant spike during the 2008 financial crisis.

The credit facilities to SPEs are often privately negotiated transactions structured similarly to traditional Asset Based Lending (“ABL”) facilities in which banks agree to lend funds against the value of a predefined pool of assets with the proceeds typically utilized for working capital, to purchase additional assets or other general corporate purposes. The primary purpose of the SPE is to allow for structuring that results in credit enhancement, which decreases the risk for banks and typically lowers the cost and increases the availability of credit to customers. In fact, many well-known investment grade and non-investment grade issuers utilize credit facilities originated with SPE subsidiaries. Additionally, many corporate borrowers have a secured credit facility at an SPE subsidiary in combination with a more traditional unsecured or secured revolving credit facility at the corporate parent.

The final U.S. LCR rules should be supportive of credit facilities to SPEs as this form of lending provides credit enhancement through several structural enhancements including overcollateralization and the bankruptcy remote nature of the transaction. This allows U.S. banks to maintain a superior risk position vis-à-vis other unsecured and secured creditors, which supports the safety and soundness of the U.S. banking system. If the SPE definition is unchanged U.S. banks could be encouraged to forego the benefits of the SPE structure, potentially increasing the risk of loss.

We believe that credit facilities to SPEs that have no short-term market based funding maturing or putable within 30 days, should be prescribed an outflow amount consistent with an undrawn credit facility made directly to the SPE parent or sponsor, or a “look-through approach,” which would range from 10% to 50% depending on the parent or sponsor counterparty type. Conversely, credit or liquidity facilities to SPEs with short-term market based funding should be prescribed a 100% draw factor, indicating the high likelihood of draw during a period of liquidity stress. This would include commitments to SIVs and other similar vehicles that have outstanding unsecured commercial paper, asset-backed commercial paper, short-term repurchase agreements, or other short-term notes maturing within 30 days.

### **Treatment and Definition of Commercial Paper Backup Facilities<sup>17</sup>**

*The portion of unfunded loan facilities that do not back outstanding commercial paper or other similar short-term instruments should be considered credit facilities, not liquidity facilities.*

In the International Liquidity Standards and subsequent FAQ clarifications and Instructions for Basel III monitoring published by the Basel Committee, the unfunded portions of committed loan facilities are categorized in three parts:

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<sup>17</sup> This section is in response to Question 42 within the NPR as it relates to commercial paper backup facilities.

1. The portion of the committed, undrawn facility that is backing commercial paper maturing within a 30-day period is treated as a liquidity facility;
2. The portion of the committed, undrawn facility that is backing commercial paper that does not mature within the 30-day window is excluded from the scope of the definition of a facility; and
3. Any additional capacity of the committed, undrawn facility (i.e. the remaining commitment) is treated as a credit facility

The intention of the International Liquidity Standards is to characterize each portion of these facilities differently in order to properly recognize the risk of a customer draw during times of stress. Under this methodology, for a non-financial corporate borrower, the portion of the facility that backs commercial paper maturing within a 30-day period is prescribed a 30% commitment outflow amount, while the additional capacity that is treated as a credit facility is prescribed a 10% commitment outflow amount. This bifurcation method properly rank orders the risk of draw and requires banks to further differentiate their credit facilities in order to determine their *pro rata* share of draw risk from their customers' commercial paper programs.

To that end, Wells Fargo committed significant time and effort during late 2012 and early 2013 to improve the process for identifying exposure to commercial paper programs, including an estimate for the amount of commercial paper for each customer that is maturing within a 30-day period. This new process reduced the level of management judgment and improved our insight into exposure to commercial paper programs. The new method utilizes granular issuer level data and market data to determine commercial paper outstandings and unfunded commitments for commercial paper issuers. Through this process, we are able to properly quantify the portions of the facilities that backstop outstanding commercial paper maturing within a 30-day period, the portions of the facilities that backstop commercial paper that does not mature within the 30-day window, and the portions of the facilities that are not serving as a commercial paper backstop.

Under the Proposed LCR Rule, a liquidity facility is defined as “a legally binding agreement to extend funds at a future date to a counterparty that is made expressly for the purpose of refinancing the debt of the counterparty when it is unable to obtain a primary or anticipated source of funding. A liquidity facility includes an agreement to provide liquidity support to asset-backed commercial paper by lending to, or purchasing assets from, any structure, program or conduit in the event that funds are required to repay maturing asset-backed commercial paper. Liquidity facilities exclude facilities that are established solely for the purpose of general working capital, such as revolving credit facilities for general corporate or working capital purposes.”<sup>18</sup>, while a credit facility is defined as “a legally binding agreement to extend funds if requested at a future date, including a general working capital facility such as a revolving credit facility for general corporate or working capital purposes. Credit facilities do not include facilities extended expressly for the purpose of refinancing the debt of a counterparty that is

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<sup>18</sup> Proposed LCR Rule in § \_\_.3.

otherwise unable to meet its obligations in the ordinary course of business (including through its usual sources of funding or other anticipated sources of funding).”<sup>19</sup>

Similar to the International Liquidity Standards, the portion of a liquidity facility that supports customer obligations that do not mature within 30 calendar days of the calculate date are excluded from the scope of the definition of a facility. However, the preamble of the Proposed LCR Rule notes that facilities that have aspects of both credit and liquidity facilities would be classified as liquidity facilities for the purposes of the Proposed LCR Rule. It is unclear how exactly this standard is to be practically applied as the majority of facilities that act as commercial paper backup facilities can also be utilized for other general corporate purposes, while other credit facilities are often allowed to function as a commercial paper backstop under the permitted uses within the credit agreements. In other words, credit and liquidity facilities are often not separate and distinct facilities in the United States.

Paragraph (3)(2)(ii) of § \_\_.32 implies that all portions of facilities that have been identified as serving as a commercial paper backstops except for the portion that supports commercial paper that does not mature within 30 days, would be classified as a liquidity facility by default. As a result, the portions of facilities that by definition are not backing commercial paper (i.e. general credit facilities) receive a higher commitment outflow rate than under the International Liquidity Standards. We believe the treatment of this portion of a committed facility as a liquidity facility is punitive, does not match the intent of the International Liquidity Standards, and is illogical in light of the procedures that firms such as Wells Fargo have put in place to track commercial paper outstandings and maturity profiles at a granular level in order to properly quantify the portions of the facilities that do not back commercial paper. Therefore we recommend reverting back to the definition and instructions found in the International Liquidity Standards.

### **Treatment of Indeterminate Cash Outflows within the Test for the Highest Amount of Net Cumulative Cash Outflows<sup>20</sup>**

*The assumption that all commitment outflows and deposit outflows from indeterminate wholesale deposits and all retail deposits occur on the first day is unreasonable and consequently should be amended.*

Under the Proposed LCR Rule, the total net cash outflow amount is the dollar amount on the day within a 30 calendar-day stress period that has the highest amount of net cumulative cash outflows. We agree this is an improvement that addresses potential maturity mismatches as compared to the International Liquidity Standards which uses the total net cash outflow over the 30 calendar-day stress period without regard to timing. However, as currently drafted, the Proposed LCR Rule leads to an unreasonable result with respect to non-maturity cash outflows, which are required to be reflected on the first day of the 30 calendar-day stress period. These

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<sup>19</sup> Proposed LCR Rule in § \_\_.3.

<sup>20</sup> This section is in response to Questions 28 and 29 within the NPR.

non-maturity cash outflows include indeterminate deposit outflows, retail term deposits irrespective of whether the maturity is more than 30 days, and all assumed draws on loan commitments, which together can represent the majority of all outflows for a bank. This “first day” requirement is overly conservative as it is not realistic for an event to occur, get publicized, and have the entirety of customer reactions occur within 24 hours. The effect of the requirement is to accelerate the determination of the day within a 30 calendar-day stress period that has the highest net cumulative cash outflows, and unjustifiably disallow certain cash inflows that are expected to occur over the remainder of the 30 calendar-day stress period. Ironically, this approach penalizes banks with a high mix of consumer deposits, which in spite of having an indeterminate maturity, are among the most stable sources of funding.

In addition, this requirement is inconsistent with the liquidity coverage ratio proposed for smaller, less complex banking organizations (the “Proposed Modified LCR Rule”), which does not require the calculation of a peak maximum cumulative outflow day and therefore effectively affords “straight-line” treatment to such non-maturity cash outflows over the stress period.<sup>21</sup> This results in a significantly different outcome for an identical deposit or loan commitment at a covered company vs. a banking organization applying the Proposed Modified LCR Rule.

We therefore recommend that the appropriate assumption of straight-line treatment on non-maturity cash outflows that exists in the Proposed Modified LCR Rule be adopted in the Final LCR Rule applicable to covered companies as well. Another alternative would be a slightly front-loaded approach, such as one that results in 5.0% of the non-maturity cash outflows occurring per day over first 7 days of the stress period, 4.0% per day over the next 7 days, 3.0% per day over the next 7 days, and 1.8% per day over the remaining 9 days. It is inappropriate for the Final LCR Rule to contain the requirement that all non-maturity cash outflows occur on the first day of the 30 calendar-day stress period.

### **Treatment of Contractually Defined Notice Periods<sup>22</sup>**

*Contractually defined notice periods should not be disregarded asymmetrically and should be viewed as legally binding for wholesale counterparties.*

Under the Proposed LCR Rule, in determining maturity dates for net cash outflows, contractually defined notice periods are disregarded when applied to outflows such that an investor’s option to shorten the maturity date of a funding transaction will occur at the earliest possible maturity date regardless of the notice period; while for inflows the latest possible maturity date must be assumed based on the borrower using the entire notice period. Furthermore this asymmetric treatment is applied equally to both retail and wholesale customers.

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<sup>21</sup> The Proposed Modified LCR Rule applies to banking organizations with at least \$50 billion in total consolidated assets that are not covered companies under the Proposed LCR Rule.

<sup>22</sup> This section is in response to Questions 30 and 31 within the NPR as it relates to notice periods.

We acknowledge an incentive might exist for banks to disregard notice periods in transactions with retail counterparties given the ensuing potential reputational risk that could occur for failing to do so. However for transactions involving wholesale counterparties, we believe contractually defined notice periods should be and would be honored. Wholesale counterparties initiate contractual commitments in all aspects of their business activities and operate themselves pursuant to the obligations created by those commitments. They are expected to employ the resources to assess the impacts of those commitments and our legal framework enforces their performance on the contracts they execute. These expectations are recognized in the International Liquidity Standards which state that wholesale funding that is callable by the funds provider subject to a contractually defined and binding notice period surpassing the 30-day horizon is not included in outflows from unsecured wholesale funding run-off.<sup>23</sup>

Additionally, disregarding notice periods in determining maturity dates for wholesale outflows creates a further inconsistency in the Proposed LCR Rule since a 30-day notice period is one of the requirements that must be satisfied in order to classify wholesale deposits as operational. The Proposed LCR Rule states that a deposit must be held pursuant to a legally binding written agreement, the termination of which is subject to a minimum 30 calendar-day notice period or significant termination costs are borne by the customer providing the deposit if a majority of the deposit balance is withdrawn from the operational deposit prior to the end of a 30 calendar-day notice period.<sup>24</sup>

Wells Fargo recommends differentiating between retail and wholesale counterparties in the provisions relating to notice periods in Subpart D §\_.31 such that contractually binding notice periods included in contracts with wholesale counterparties are considered and not disregarded when determining maturity dates of those transactions.

### **Treatment of Operating Costs, such as Salaries<sup>25</sup>**

*Operating costs, such as salaries payable, should be excluded from net cash outflows.*

Under the Proposed LCR Rule, the total net cash outflow amount would include a 100% outflow rate for any contractual amounts payable within 30 days that are not otherwise specified and cites operating costs such as salaries payable as an example. At the same time, the Proposed LCR Rule defines cash inflows to exclude any not related to financial transactions. The International Liquidity Standards are similar with respect to allowable cash inflows, however, excludes operating costs from net cash outflows.<sup>26</sup> As a result, the Proposed LCR Rule is inconsistent with the International Liquidity Standards in a way that is not explained or justified and adds an unnecessary level of complexity. Banks can be expected to generate positive operating cash flow even during crises, given that the largest components of accounting losses are not cash related (e.g. loan losses, goodwill write-downs, etc.). It is net cash outflows from

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<sup>23</sup> See International Liquidity Standard at Paragraph 87.

<sup>24</sup> Proposed LCR Rule in Subpart A §\_.4.

<sup>25</sup> This section is in response to Question 59 within the Proposed LCR Rule.

<sup>26</sup> See International Liquidity Standard at Paragraph 87.

financial transactions that are most likely to negatively impact a bank's liquidity during a stress period. We therefore recommend that operating costs such as salaries payable be excluded from net cash outflows consistent with International Liquidity Standards.

### **Outflow Rates of Mortgage Escrow Deposits<sup>27</sup>**

*The proposed outflow rates for mortgage escrow should revert to the treatment under International Liquidity Standards.*

Mortgage escrow deposits represents principal, interest, taxes, and insurance (PITI) held in custodial bank accounts until remitted to investors, taxing authorities, and home insurance providers. The deposits are maintained in conjunction with mortgage loan servicing and in accordance with investor servicer guidelines. Custodial bank accounts are titled in investor's name; however, the accounts are FDIC insured up to \$250,000 per mortgagor.<sup>28</sup> Given this relatively high limit compared to normal monthly escrow payments, the majority of mortgage escrow deposits are fully insured. Approximately 90% of Wells Fargo's mortgage escrow deposits are FDIC insured, while 10% are over the FDIC insurance threshold. These uninsured deposit balances represent our estimate of transitory refinancing prepayments of mortgage with remaining principal balances greater than \$250,000.

Under the Proposed LCR Rule, mortgage escrow deposits are assigned a 25% outflow rate. Even though the Agencies state that mortgage escrow deposits are operational in nature, they are concerned that they "are more likely to be withdrawn upon the occurrence of a motivating event regardless of deposit insurance coverage."<sup>29</sup> This outflow rate is more conservative than the treatment under the International Liquidity Standards published by the Basel Committee. In the International Liquidity Standards, mortgage escrow deposits are considered to be a byproduct of services related to a Custody Relationship. As such, the deposits would be eligible to be classified for Operational classification subject to passing the other Operational Deposit criteria. Assuming an industry mix of insured vs. uninsured mortgage escrow deposit similar to Wells Fargo (90% insured) and that the vast majority of these deposits would qualify for Operational Deposits, under the International Liquidity Standards, mortgage escrow deposits would have an average outflow rate of approximately 7%.

While we agree that investors have the right to withdraw escrow deposits in the event certain qualified servicer requirements are not met, there are many steps that would need to occur within a 30-day period for an investor to move funds to another depository institution:

- Material decline in capital, net worth, credit rating, or other triggering event occurs
- Determination of qualified servicer breach
- Investor determines best course of action to address breach

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<sup>27</sup> This section is in response to Questions 49 and 50 within the NPR as it relates to Mortgage Escrow deposits.

<sup>28</sup> See 12 CFR § 330.4

<sup>29</sup> NPR at page 71841.

- Investor has operational capability to effect withdrawals involving thousands of bank accounts

Escrow deposits are not typically separated from mortgage loan servicing, even if it involves a distressed servicer and servicing transfers typically take several months to complete in order to avoid negatively impacting borrowers. Additionally, since custodial bank accounts are FDIC insured, investors will not be motivated to move deposits to avoid losses.

There is little indication that mortgage investors would be more likely to terminate the underlying services agreement or move deposits than any other deposits associated with Custody Relationships. Furthermore, we view that these mortgage escrow accounts are no more likely to be withdrawn in a period of a financial stress than any other potential operational accounts that may be placed with the bank from the same investors. Due to these factors, we believe outflow factors associated with mortgage escrow deposits should revert to the definition within the International Liquidity Standards. Under the Operational Deposit test there are set procedures that can determine the operational as well as insured status at an account level, which allows for a more granular estimate of potential deposit attrition based on the characteristics of each deposit.

### **Operational Nature of Corporate Trust Deposits<sup>30</sup>**

*Corporate trust deposits should be explicitly eligible for consideration as operational deposits.*

Corporate trust services provides fiduciary and agency services on debt securities issued by public and private corporations, government entities, and the banking and securities industries, including mortgage-backed, asset-backed, collateralized debt obligations, municipal, and corporate/high yield securities. The bank providing these services will typically act as paying agent for the bonds and as depository bank to hold funds in trust or as agent on behalf of others. These deposits are administered strictly in accordance with the provisions of the governing agreements without discretion as to their use or application on the part of the trustee or agent. Similarly, withdrawals (e.g. those related to collection and reserve fund deposits and payment of principal, interest, fees, etc.) are not available to the underlying customer or transaction parties on a discretionary basis; rather such withdrawals are only permitted in accordance with the terms of the governing agreements.

The International Liquidity Standards include corporate trust servicing as an example of services representative of a “custodial relationship,” which is one type of activity that may generate operational deposits.<sup>31</sup> However, in the Proposed LCR Rule<sup>32</sup>, the definition of “operational services” item (10), which otherwise is consistent with paragraph 102 of the Basel LCR, excludes corporate trust servicing in its introduction. Given the nature of corporate trust servicing described above, its related activities correspond to those in items (1), (3), (7), (8), (10)

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<sup>30</sup> This section is in response to Question 49 within the NPR as it pertains to Corporate Trust deposits.

<sup>31</sup> See International Liquidity Standard at Paragraph 102.

<sup>32</sup> Proposed LCR Rule in § \_\_.3.

and (11) of the Proposed LCR Rule’s definition of “operational services.” For purposes of clarification, we respectfully ask that “corporate trust servicing” be added to the introduction of item (10) in the U.S. LCR final rule.

## **II. Comments Pertaining to High-Quality Liquid Assets**

### **HQLA Treatment of Investment Grade Municipal Securities<sup>33</sup>**

*Investment Grade U.S. municipal bonds should be treated as Level 2 HQLA.*

The Agencies have outlined that a HQLA must possess both liquidity characteristics and other qualifying criteria. To meet the liquidity criteria as a HQLA for LCR, an asset must meet the following prescribed risk profile and market-based characteristics: low risk, limited price volatility, high trading volumes, deep markets with transparent pricing, and eligible to be pledged as collateral at a central bank. For inclusion in Level 1 and Level 2, such assets must also meet the definition of “liquid and readily-marketable”<sup>34</sup>, further defined as traded in an active secondary market. The municipal bond market demonstrates each of these characteristics, particularly in periods of market stress. For the reasons described below, Wells Fargo believes that investment grade U.S. municipal securities should be eligible for designation as a High Quality Liquid Asset.

To qualify as a HQLA, the assets “generally tend to have prices that do not incur sharp price declines, even during times of stress”<sup>35</sup>. Historical evidence from the Federal Reserve and U.S. Department of Treasury shows that the prices of both AA municipal general obligation and single A municipal revenue bonds experienced less volatility than other asset classes. In comparing the largest monthly price movements over the last 90 years, the largest monthly price decline for AA-rated municipal G.O. bonds (-9.2%) was smaller than both the largest drop in U.S. Treasury prices (-11.8%) and in BBB corporate bonds (-15.7%). During the financial crisis of 2008, A-rated municipal revenue bond prices depreciated less than BBB-rated corporate bonds, which qualify as a HQLA under the current proposal. These observations support the argument that municipal bonds exhibit low risk and limited price volatility during periods of stress, and that this asset class possesses characteristics consistent with other HQLA.

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<sup>33</sup> This section is in response to Questions 3, 9, 12, 15, and 22 within the NPR as it pertains to Municipal securities.

<sup>34</sup> See generally, Section B of NPR.

<sup>35</sup> NPR at page 71824

**Figure 5: Monthly Price Declines by Asset Class<sup>36</sup>**

Asset Class	Worst Monthly Price Declines		5 Worst Monthly Price Declines
	Date	Price % Change	Avg. Price % Change
U.S. Treasuries	Feb-80	-11.80%	-7.80%
AAA Corporate Bonds	Feb-80	-9.70%	-7.42%
AA Municipal General Obligations	Apr-87	-9.20%	-8.48%
Single A Municipal Revenue Obligations	Oct-08	-10.30%	-9.04%
BBB Corporate Debt	Oct-08	-15.70%	-12.22%

In addition to price stability, the Agencies assert that a HQLA tends to trade in high volume. Because municipal debt is typically issued with a serial maturity structure, it is common for a single issuer to have hundreds or thousands of individual CUSIPs outstanding. Consequently, the municipal securities market has over one million CUSIPs outstanding, many of which do not trade frequently on an observed basis. In the municipal securities market, aggregate trading volumes are a more appropriate metric to consider as evidence of liquidity, however, since the market tends to view the similarly structured securities (coupon and maturity) of an individual obligor as reasonable substitutes from a dealer and investor perspective. For this reason, the volume of bonds traded relative to total debt outstanding of the issuer is a more meaningful method to assess liquidity. For example, the State of California currently has nearly 1,800 separate CUSIPs.<sup>37</sup> While each individual CUSIP may not trade on a regular basis, a price for any of the CUSIPs can be readily quoted by a dealer based on where other California general obligations bonds have recently traded. In 2013, 0.30% of all State of California GO debt market traded daily.<sup>38</sup> In this context, the market for this issuer is active, consisting of a large number of transactions and securities that can be easily and readily valued – even if all 1,800 CUSIPs do not transact daily.

Assessing trading volume versus aggregate debt outstanding across asset classes, the trading volume of municipal bonds compares favorably to other asset classes classified as HQLA. According to data published by SIFMA, the daily trading volumes for municipal bonds averaged 0.30% of total par outstanding in 2013. In comparison, GSE debt traded 0.32% daily and

<sup>36</sup> Values are based on monthly averages of daily or weekly yield data for the period beginning January 1925 through October 2013. Price conversions were calculated assuming par coupons equal to each prior period's average rate. U.S. Treasury Long-Term Composite yields for January 1925 through June 2000 are sourced from the Federal Reserve's H.15 Interest Rate Tables; yield data for July 2000 through October 2013 is published by the U.S. Department of the Treasury's online Data Center. AAA and BBB corporate bond yields are from the Federal Reserve's H.15 Interest Rate Tables. AA municipal general obligation and single-A revenue obligation yields come from Bond Buyer data for the "20-Bond GO Index" and "Revenue Bond Index" respectively. Price conversions assume a 20-year maturity for the U.S. Treasury Long-Term Composite, a 25-year maturity for AAA and BBB corporate bonds, a 20-year maturity for AA municipal general obligation and 30-year maturity for single-A municipal bonds.

<sup>37</sup> Based on January 15, 2014 Bloomberg data, "MSRC" function results based on criteria for State of California, GO, outstanding, taxable and tax-exempt, excluding CA ERB bonds, and excluding derivatives.

<sup>38</sup> Based on general obligation debt outstanding from the California Treasurer's Debt Affordability Report, as of June 30, 2013 and on trading volume data provided by the Municipal Securities Rulemaking Board's ("MSRB") Electronic Municipal Market Access ("EMMA") Trade Data via Citigroup.

corporate debt traded 0.19% daily. In 2008, daily trading volumes for municipal securities averaged 0.52% of par outstanding, higher than either 2012 or 2013.<sup>39</sup> For example, during the fourth quarter of 2008, the daily trading volume for the State of California general obligation debt averaged 0.42% of total par outstanding, higher than in 2013 (i.e., 0.30% of total par outstanding).<sup>40</sup> Both observations support the concept of right-way risk during a period of stress, which is an element in consideration of HQLA eligibility.

**Figure 6: 2013 Trading Volume by Asset Class<sup>41</sup>**

Asset Class	Definition	Outstanding Market Size (\$bn)	Avg. Daily Trading Volume (\$bn)	% Market Traded Daily
Municipal Debt	All municipal debt	3,685.7	11.2	0.30%
GSEs	Agency debt of Fannie Mae, Freddie Mac, Farmer Mac, FHLB, the Farm Credit System, and federal budget agencies (e.g., TVA)	2,049.2	6.5	0.32%
Corporate Debt	All non-convertible debt, MTNs and Yankee bonds, but excludes CDs and federal agency debt	9,561.7	18.1	0.19%
Mortgage Related	GNMA, FNMA, and FHLMC mortgage-backed securities and CMOs and private-label MBS/CMO	8,671.6	227.5	2.62%

The Agencies note that a deep and transparent market is another fundamental determinant of liquidity. In this respect, an asset class must be traded in the secondary market with more than two committed market makers, involve a large number of non-market making buy and sell side participants, and provide observable prices. The municipal market is robust in both aspects of market participation. The Municipal Securities Rulemaking Board (MSRB) currently regulates 1,664 registered broker-dealers who provide market making functions for the municipal market.<sup>42</sup> In addition, municipal securities are held by a broad and diverse base of investors. According to the Z.1 statistical release of Financial Accounts of the United States, published by the Federal Reserve on December 9, 2013, the largest holders of municipal bonds are as follows:

<sup>39</sup> Historical annualized par outstanding for municipal bond sector published by SIFMA on January 8, 2014. Average daily trading volume statistics for municipal bond sector published by SIFMA on January 7, 2014, specifically consists of annualized data for 2008, 2012, and 2013.

<sup>40</sup> Based on general obligation debt outstanding from the California Treasurer's Debt Affordability Report, as of June 30, 2008 and on trading volume data provided the Municipal Securities Rulemaking Board's ("MSRB") Electronic Municipal Market Access ("EMMA") Trade Data via Citigroup.

<sup>41</sup> Par Outstanding as of 3Q2013 for each asset class published by SIFMA on January 8, 2014. Average daily trading volume statistics published by SIFMA on January 7, 2014, specifically consists of annualized data for 2013.

<sup>42</sup> Data published by MSRB as of January 15, 2014.

**Figure 7: Municipal Holdings by Sector<sup>43</sup>**

Sector	Holdings (\$bn)	% Total Market
Household sector	1,639.9	44.49%
Mutual funds	620.5	16.84%
U.S.-chartered depository institutions	404.0	10.96%
Insurance Companies	331.9	9.01%
Money market mutual funds	305.1	8.28%
Other	251.2	6.82%
Life insurance companies	133.2	3.61%
<b>Total Municipal Market</b>	<b>3,685.7</b>	<b>100%</b>

The household sector, the largest holder of municipal bonds, reflects an extremely large number of investors. This retail base historically has demonstrated increased demand to purchase municipal securities when yields rise, another example of right-way risk for this asset class.

The Agencies propose that assets that can be pledged “as collateral for intraday liquidity needs and overnight liquidity facilities in a jurisdiction and in a currency where the bank has access to the central bank generally tend to be liquid and, as such, are appropriate for consideration as HQLA.”<sup>44</sup> Municipal bonds are accepted at the Federal Reserve discount window at a 2% to 5% haircut. By comparison, corporate bonds are accepted with larger haircuts: 3% to 6% for AAA rated bonds, and 5% to 8% for BBB to AA rated bonds.<sup>45</sup>

In summary, municipal securities as an asset class retain the risk profile, market-based characteristics and central bank eligibility status that are consistent with a High Quality Liquidity Asset. In comparison to other asset classes classified as either Level 2A or L2B assets, municipal bonds compare favorably in each liquidity criteria – even in periods of market stress.

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<sup>43</sup> Data published in Table L.211 of Z.1 Statistical Release of Financial Accounts of the United States on December 9, 2013.

<sup>44</sup> NPR at Section A.1(c) on Central Bank Eligibility

<sup>45</sup> Federal Reserve Discount Window & Payment System Risk Collateral Margins Table, Effective Date: October 19,2009, updated January 2, 2013

**Figure 8: Comparison of Liquidity Characteristics by Asset Class<sup>46</sup>**

Asset Class	Largest Monthly Price Drop Since 1925	2013 Avg. Daily Trading Volume	Central Bank Eligibility	HQLA Classification
Municipal Bonds	-9.2% <sup>47</sup> -10.3% <sup>48</sup>	0.30%	Yes – 2% to 5% haircut	Not Eligible
Investment Grade Corporate Bonds	-15.7% <sup>49</sup>	0.19%	Yes – 3% to 8% haircut	L 2B
GSEs	not evaluated	0.32%	Yes – 2% to 9% haircut	L 2A
U.S Treasuries	-11.8%	4.71%	Yes – 1% to 4%	L 1

Further, the Proposed LCR Rule allows obligations of foreign sovereign entities to either be classified as Level 1 or Level 2A, depending on the country. The inconsistent treatment of foreign debt versus U.S. municipal debt creates an unwarranted bias against U.S. public sector debt. For these reasons, we recommend the Proposed LCR Rule be modified to include U.S. investment grade municipal bonds as a Level 2 asset. We believe that the evidence supports the Level 2A classification (consistent with International Liquidity Standards); therefore, it seems inappropriate to have municipal bonds excluded from Level 2 altogether.

Moreover, the exclusion of this asset class from HQLA eligibility will have detrimental consequences for the municipal market, including higher costs to municipal issuers and taxpayer constituents. Banks, an active and important investor of long dated municipal debt, will have less demand for municipal securities, creating negative ripple effects for the entire municipal market. In addition, the municipal asset class, a relatively small percentage of the total investment portfolios of U.S. depository institutions, serves as an important portfolio diversification tool and helps to reduce systemic risk. Finally, the omission of municipal securities from HQLA could reshape the municipal market to be less liquid, introducing problems that otherwise do not currently exist and unintentionally undermining the original intent of the Proposed LCR Rule. All of these characteristics underscore the important role of the municipal bond sector in the market and further support the case for the inclusion of municipal securities as HQLA.

### **HQLA Treatment of GSE Securities<sup>50</sup>**

*We continue to believe that GSE securities should receive more favorable treatment as HQLA.*

Under the Proposed LCR Rule, GSE securities are subject to a 15% haircut and, coupled with other Level 2A and 2B assets, a 40% cap of the total stock of HQLA. These limitations are likely to incentivize banks to reduce their holdings of GSE MBS, thereby resulting in an increase in

<sup>46</sup> This table consolidates data previously referenced and cited throughout the letter.

<sup>47</sup> For AA municipal bonds.

<sup>48</sup> For single A municipal revenue bonds.

<sup>49</sup> For BBB rated corporate bonds.

<sup>50</sup> This section is in response to Questions 3, 9, 10, 14, and 22 within the NPR as it pertains to GSE securities.

mortgage loan interest rates to consumers and a negative effect on the housing market and the broader economy generally.

GSE securities are liquid and easily convertible to cash. There are currently over \$4 trillion in GSE MBS outstanding.<sup>51</sup> Daily trading volume in GSE MBS averages almost \$230 billion.<sup>52</sup> Daily repo volume of GSE MBS is similar to that of U.S. Treasuries.<sup>53</sup> It is clear that these securities demonstrate significant liquidity.

While GSE securities are not explicitly guaranteed by the full faith and credit of the U.S. government, they are among the highest quality and comprise one of the most liquid markets in the world. In fact, only two markets, U.S. Treasuries and Japanese Government bonds, have larger markets than the GSE MBS market and only U.S. Treasuries exhibited greater liquidity during the 2008 financial crisis.

Moreover, we believe GSE Securities should at least receive Level 1 treatment for so long as Fannie Mae and Freddie Mac are in conservatorship and are supported by the Preferred Stock Purchase Agreement with the U.S. Treasury. This would be consistent with the approach taken in the re-proposal of the Credit Risk Retention rules (the “Risk Retention Re-Proposal”) issued jointly by the Board of Governors of the Federal Reserve System, the Department of Housing and Urban Development, the Federal Deposit Insurance Corporation, the Federal Housing Finance Agency, the Office of the Comptroller of the Currency, and the Securities and Exchange Commission in August of 2013, which recognized from a practical, as well as a public policy, perspective the inherent value in FHFA’s role as conservator and the benefits of the capital support being provided by the U.S. Treasury.

Additionally, some have questioned whether there currently exists a sufficient supply of U.S. Treasuries for U.S. banks to satisfy the LCR.<sup>54</sup> Exclusion of GSE Securities from the 40% cap would at least allow U.S. banks to include one of the most liquid of their assets in the LCR calculation, albeit at a haircut. Therefore, if the Agencies refuse to treat GSE securities as Level 1 HQLA, we would respectfully request that they not be subject to the 40% cap imposed on Level 2A and 2B assets.

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<sup>51</sup> Source: <http://www.sifma.org/uploadedFiles/Research/Statistics/StatisticsFiles/SF-US-Agency-MBS-SIFMA.xls?n=44617>.

<sup>52</sup> Source: <http://www.sifma.org/uploadedFiles/Research/Statistics/StatisticsFiles/SF-US-SF-Trading-Volume-SIFMA.xls?n=28157>.

<sup>53</sup> *The Clearing House, The Basel III Liquidity Framework: Impacts and Recommendations*, November 2, 2011, page 12.

<sup>54</sup> David Rand and Martin A. Nowak, *Individual-institution and Systemic Risk Implications of the Basel III Liquidity Coverage Ratio*, January 6, 2013 Working Paper DRAFT, page 9.

## **HQLA Treatment of Certain Private Label RMBS Securities<sup>55</sup>**

*Certain Private label RMBS backed by Qualified Mortgages should be considered for future inclusion in HQLA.*

The International Liquidity Standards published by the Basel Committee includes RMBS rated AA or better as a Level 2B liquid asset with a 25% haircut, so long as all of the underlying mortgage loans have full recourse back to the borrower's assets. Under the Proposed LCR Rules, private label RMBS likely would not qualify as HQLA. We believe that U.S. regulatory agencies should be open to eventually including RMBS backed by Qualified Mortgages (as defined by the Consumer Financial Protection Bureau (the "CFPB")), which meet certain liquidity standards and are "investment grade" under the OCC's investment regulation as Level 2B HQLA.

In January 2013 the CFPB issued rules (the "ATR Rules") requiring lenders to make a reasonable, good faith determination of a consumer's ability to repay any consumer credit transaction secured by a dwelling (other than certain open-ended credit plans, timeshare plans, reverse mortgages or temporary loans). These rules became effective on January 10, 2014. The ATR Rules also include a definition of "Qualified Mortgages." Qualified Mortgages are loans with low risk features and are presumed to comply with the ATR Rules. In order to fall within the Qualified Mortgage definition, loans must not have a negative amortization feature, an interest only period, a term longer than 30 years, or, in most cases, a balloon payment. Additionally, loans that are not eligible for purchase, guarantee or insurance by one of the GSEs, FHA, VA or USDA, generally require a borrower debt-to-income ratio of 43% or less in order to satisfy the Qualified Mortgage definition.

In May 2013, the FHFA announced that it was directing FNMA and FHLMC to limit their future mortgages acquisitions to loans that meet the Qualified Mortgage standard, including those that meet the special or temporary qualified mortgage definition, and loans that are exempt from the "ability to repay" requirements under Dodd-Frank. The Board of Governors of the Federal Reserve System, the Department of Housing and Urban Development, the Federal Deposit Insurance Corporation, the Federal Housing Finance Agency, the Office of the Comptroller of the Currency, and the Securities and Exchange Commission, in the Credit Risk Retention Re-Proposal, explicitly recognized the high quality of Qualified Mortgages when they proposed an exemption from the risk retention requirements for RMBS backed by these loans.<sup>56</sup> The requirement that FNMA and FHLMC purchase mortgages under the QM standard and that RMBS transactions backed back QM would be exempt from the risk retention requirements under the most recent proposal represent an elevated status for QM based on the stringent underwriting standards and lower expected credit risk. Investors reward securities that have

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<sup>55</sup> This section is in response to Questions 3, 9, 15, and 22 within the NPR as it pertains to private RMBS securities.

<sup>56</sup> "The QM definition excludes many loans with riskier product features, such as negative amortization and interest-only payments, and requires consideration and verification of a borrower's income or assets and debt. This approach both protects the consumer and should lead to lower risk of default on loans that qualify as QM." Credit Risk Retention, Proposed Rule, 78 FR 57989.

lower credit risk expectations with broader market acceptance and greater liquidity. Therefore, it is reasonable to assume that RMBS backed by Qualified Mortgages will enjoy liquidity benefits that other RMBS do not. Of course, HQLA should only include assets with a potential to generate liquidity through sale or secured borrowing during a stress scenario. Requiring RMBS be registered with the SEC or otherwise traded in the 144A markets in order to qualify as HQLA is one way of ensuring the broadest possible available market. Additionally, if the Agencies are concerned that the data available regarding the liquidity of the Qualified Mortgage-backed RMBS market is not fully developed, limiting HQLA RMBS to issuances of sponsors whose securities have a proven track record as a reliable source of liquidity as determined by reference to market price and secured lending haircuts would help to address these concerns. This approach, similar to the approach for corporate debt securities, will ensure that RMBS included in HQLA are appropriately liquid assets in times of stress.

Although most U.S. RMBS would not be backed solely by mortgage loans with full recourse to the borrower's assets<sup>57</sup>, we believe, as a general matter, that a portfolio of Qualified Mortgages has far greater intrinsic value than a portfolio of mortgages which include the potential for an additional unsecured claim against the borrower.

We are concerned that discouraging banks from being active participants in the private label RMBS markets by eliminating any liquidity credit for these assets will impede the return of private capital to the residential mortgage market. Treatment of RMBS as Level 2B HQLA as described herein (i) will provide for greater diversification in U.S. banks' LCR portfolios, (ii) is consistent with the principals of the International Liquidity Standards, (iii) will encourage sound lending and underwriting by banks and other mortgage originators, and (iv) will encourage the return of private capital to the mortgage market, thereby reducing the exposure of U.S. taxpayers.

### **III. Comments Pertaining to Liquidity Coverage Ratio Shortfall**

#### **Procedures in Response to Potential LCR Shortfalls<sup>58</sup>**

*Procedures should be triggered based on a 5% LCR shortfall.*

Beyond normal volatility in bank cash positions arising from customer actions, the HQLA cap calculation in the proposed LCR introduces significant volatility into the ratio through a multiplier effect whereby a \$1 decline in cash can result in a \$1.67 decline in HQLA. The Agencies likely gave a tacit acknowledgement of that volatility in their construct of how firms should address instances when their LCR drops below 100%. The proposed response to a shortfall is notification to the primary regulator on any day a shortfall occurs, and if it persists for 3 consecutive business days, a remediation plan must be filed.

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<sup>57</sup> The following U.S. states prohibit such mortgage loans: (1) Alaska; (2) Arizona; (3) California; (4) Connecticut; (5) Idaho; (6) Minnesota; (7) North Carolina; (8) North Dakota; (9) Oregon; (10) Texas; (11) Utah; and (12) Washington.

<sup>58</sup> This section is in response to Questions 66-71 within the NPR.

We believe it is likely that the LCR will be the binding constraint for most firms rather than their internal measures, given the explicit conservative bias taken by the FRB, and the difficulty in securing appropriate empirical data. If so, then we believe that the nature of the LCR changes from an inviolable minimum to a standard around which some variability is permitted. As such, a construct to accommodate normal, inconsequential fluctuations in a firm's day-to-day liquidity position is important, and we encourage the Agencies to consider providing slightly more flexibility than is currently proposed.

Our concern stems from the likely ramifications of having to file a remediation plan, specifically that such a plan could be considered a material fact requiring immediate public disclosure under SEC Rules 13a-11 and 15d-11, as well as New York Stock Exchange listing rules. Immediate disclosure is at odds with what the Basel Committee has acknowledged in their choice of disclosure schemes: that disclosure of liquidity positions, unlike other facets of a Bank's performance, can actually cause liquidity events. In the case of a LCR ratio shortfall, such disclosure could undermine a bank's ability to execute transactions to eliminate it, and could unnecessarily compromise confidence in the financial system. To avoid this, an ex-post scheme of reporting liquidity results on a lagged basis was chosen over a contemporaneous disclosure scheme.<sup>59</sup>

One way to moderate our concern in this area would be to introduce a measure of severity into requirements surrounding an LCR shortfall. We believe it would be appropriate to require a remediation plan only if a shortfall exceeded 5% (i.e. an LCR ratio of less than 95%) and persisted for 3 days. Such a scheme would help avoid having to disclose minor breaches that can easily occur given the volatility inherent in the cap calculation. And introduction of a "corridor" concept is a well-accepted mechanism to handle volatile items. Should a formal remediation plan be required, the banking organization's CFP should be used together with a memo outlining the specific actions taken and contemplated to remediate the LCR shortfall.

Finally, existing supervisory processes and procedures are sufficient to address any concern the Agencies have concern about such a "corridor" being abused.

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In summary, we believe an effective LCR is an important and useful tool, but believe in many instances the Agencies should more closely adhere to the International Liquidity Standards.

We appreciate your consideration of our comments. We will gladly make ourselves available for any further consultations and/or questions you may have, and would also be happy to provide

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<sup>59</sup> *Basel Committee on Banking Supervision, Liquidity coverage ratio disclosure standards*, January 2014.

our thoughts on regulatory text that would implement the suggestions above. Please contact me at 415-396-5196 if we can assist you in any way.

Sincerely,

A handwritten signature in black ink, appearing to read "Paul R. Ackerman". The signature is fluid and cursive, with the first name "Paul" being the most prominent.

Paul Ackerman  
Executive Vice President &  
Treasurer