BETTER MARKETS

August 5, 2016

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Mr. Robert deV. Frierson
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Mr. Robert E. Feldman
Executive Secretary
Attention: Comments/Legal ESS
Federal Deposit Insurance Corporation
550 17th Street NW
Washington, D.C. 20429

Re: Net Stable Funding Ratio: Liquidity Risk Measurement Standards and Disclosure Requirements (OCC Docket ID OCC 2014-0029; Board Docket No. R-1537, RIN 7100 AE-51; FDIC RIN: 3064-AE44)

Ladies and Gentlemen:

Better Markets[1] appreciates the opportunity to comment on the above-captioned rule proposed ("Proposed Rule") by the Office of the Comptroller of the Currency, the Board of

[1] Better Markets is a non-profit, non-partisan, and independent organization founded in the wake of the 2008 financial crisis to promote the public interest in the financial markets, support the financial reform of Wall Street, and make our financial system work for all Americans again. Better Markets works with allies—including many in finance—to promote pro-market, pro-business, and pro-growth policies that help build a stronger, safer financial system that protects and promotes Americans' jobs, savings, retirements, and more.

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Governors of the Federal Reserve System, and the Federal Deposit Insurance Corporation ("the Agencies"). The Proposed Rule implements a stable funding requirement—the Net Stable Funding Ratio ("NSFR") for large, internationally active banking organizations. As the Basel Committee on Banking Supervision has explained,

> The NSFR will require banks to maintain a stable funding profile in relation to the composition of their assets and off-balance sheet activities. A sustainable funding structure is intended to reduce the likelihood that disruptions to a bank's regular sources of funding will erode its liquidity position in a way that would increase the risk of its failure and potentially lead to broader systemic stress. The NSFR limits overreliance on short-term wholesale funding, encourages better assessment of funding risk across all on- and off-balance sheet items, and promotes funding stability.[2]

The Proposed Rule would help ensure that the assets of large banking organizations are supported by stable funding sources over a one-year horizon by preventing these institutions from overly relying on short-term funding to support long-term assets.

Brandeis University finance professor Stephen Cecchetti succinctly explained the purpose behind the NSFR: limiting the maturity mismatch between a bank's assets and liabilities by "requiring banks with long-term assets to have long-term liabilities" while allowing only those banks "with short-term assets to issue short-term liabilities." As Professor Cecchetti noted, "the idea is fairly simple: banks should not do what they did prior to the crisis, which was to rely on short-term interbank or repo funding to support large volumes of long-maturity securities."[3]

COMMENTS

Better Markets strongly supports the proposed Net Stable Funding Ratio.

Better Markets strongly supports the Agencies' Proposed Rule. As the last financial crisis so painfully and expensively demonstrated, reducing the risk that arises from the inability or unwillingness of large financial institutions to manage their liquidity risk is an essential component of making financial institutions and the financial system more resilient and better able to withstand shocks and panics. Together with the Liquidity Coverage Ratio, which requires large financial institutions to maintain a stock of high-quality liquid assets sufficient to meet expected net cash outflows over a short-term liquidity stress scenario, the Proposed Rule will help ensure that large financial institutions fully internalize the costs of their funding decisions, rather than externalizing them on the broader economy in the form

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2 Basel Committee on Banking Supervision, "Basel III: the Net Stable Funding Ratio," 1 (Oct. 2014), *available at* http://www.bis.org/bcbs/publ/d295.pdf.

3 Stephen G. Cecchetti, "The Road to Financial Stability: Capital Regulation, Liquidity Regulation, and Resolution," *International Journal of Central Banking* 130 (June 2015), *available at* http://www.ijcb.org/journal/ijcb15q3a3.pdf.

of panics and crashes or relying on the munificence of the central bank to rescue them in times of crisis.

Before the financial crisis, regulators and experts believed that the only thing that financial institutions had to worry about was their solvency: these institutions had to make sure that the value of their assets exceeded their liabilities. As long as the institution's assets were worth more than its liabilities, almost everyone thought that a bank would be able to borrow what it needed to meet its obligations as they came due.[4] The financial crisis, however, demonstrated that banks not only needed to maintain an apparent positive net worth but also had to have enough cash on hand to meet their obligations as they came due. In other words, banks needed to worry about their liquidity as well. As Princeton University economist Alan Blinder explains,

> The distinction between *insolvency* and *illiquidity* is one of those lessons that both economists and financial market participants probably learned too well. The crisis made us all rethink it.
>
> In principle, the difference is stark. A firm is *insolvent* when the value of its liabilities exceeds the value of its assets, making its net worth negative. Its next stop is probably bankruptcy court. A firm is *illiquid* when it is short on cash, even if its balance sheet displays a healthy net worth. In such cases, the firm needs short-term credit, not euthanasia. Insolvency is a fatal disease; illiquidity is a bad cold . . . .
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> But here's the problem. A company facing a severe cash squeeze—especially if its usual suppliers of funding have turned their backs on it—may be forced into fire sales of its less liquid assets. Which may mean selling them at exceptionally low prices, if indeed, it can sell them at all. Which reduces net worth. The problem is worse if you're a financial company, for at least two reasons. One is that moving cash is your business. Your daily inflows and outflows of cash are likely to be extremely large compared with, say, a comparably sized manufacturing company. The second is that your leverage is likely to be high enough that even modest percentage declines in asset values translate into severe percentage declines in net worth. And it's much worse if lenders and counterparties lose confidence in you, for then the credit spigot may be turned off. . . .

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4 *See* Jean –Charles Rochet and Xavier Vives, "Coordination Failures and the Lender of Last Resort: Was Beagehot Right After All?" 2 *Journal of the European Economic Association* 1116 (2004), *available at* http://blog.iese.edu/xvives/files/2011/09/109.pdf. ("Several authors have argued that [the view that the central bank should act as a lender of last resort] is now obsolete: in modern interbank markets, a solvent bank cannot be illiquid."). But as University of Pennsylvania finance professor Franklin Allen understatedly pointed out, "in light of the recent crisis, one can have serious doubts about the validity of this argument." Franklin Allen, "How Should Bank Liquidity Be Regulated?" (March 27, 2014), *available at* https://www.frbatlanta.org/-/media/Documents/news/conferences/2014/fmc/Allen.pdf.

> For these reasons, a severe liquidity crunch can destroy a financial company, such as a commercial bank or an investment bank, even if its balance sheet is basically okay. Illiquidity can quickly turn into insolvency—as happened to Bear Stearns and, later, to Lehman Brothers.[5]

In short, financial institutions need both capital and liquidity. As the economist Charles Goodhart put it in 2007, "Liquidity and solvency are the heavenly twins of banking, frequently indistinguishable. An illiquid bank can rapidly become insolvent, and an insolvent bank illiquid."[6] Before the financial crisis, regulators focused far more attention on capital than on liquidity. In the run-up to the crisis, the financial system increasingly relied on the government to act as a backstop source of liquidity. As Professor Goodhart put it,

> Why should the banks bother with liquidity management when the Central Bank will do all that for them? The banks have been taking out a liquidity 'put' on the Central Bank; they are in effect putting the downside of liquidity risk to the Central Bank.[7]

Given the catastrophe caused by grossly insufficient liquidity before and during the financial crisis, financial regulators—for the first time ever—adopted formal standards that governed liquidity management at large, complex financial institutions. The Basel Committee on Banking Supervision reached a consensus that banks should have enough cash or easily monetizable assets (such as government securities) on hand to survive for 30 days if their usual sources of short-term funding disappear. This requirement is the Liquidity Coverage Ratio, which requires financial institutions to maintain a stock of high-quality liquid assets sufficient to meet expected net cash outflows over 30 days under an acute liquidity stress scenario.

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5 Alan Blinder, *After the Music Stopped: The Financial Crisis, the Response, and the Work Ahead* 103-04 (2013). The line between liquidity and solvency is exceedingly difficult to determine. Economists and historians continue to debate whether the financial crisis was caused by a liquidity crunch or the insolvency of large institutions, and whether institutions such as Bear Stearns and Lehman Brothers were illiquid or insolvent. The "liquidity crisis" narrative is set forth in Markus K. Brunnermeier, "Deciphering the Liquidity and Credit Crunch 2007-2008," 23 *Journal of Economic Perspectives* 77 (2009), *available at* http://www.princeton.edu/~markus/research/papers/liquidity_credit_crunch.pdf and Gary Gorton, *Slapped by the Invisible Hand: The Panic of 2007* (2010). But as Charles Goodhart and Dimitri Tsomocos have noted, the idea "that the start of the financial crisis in August 2007 was just a liquidity problem . . . was always ludicrous," given the losses suffered by large financial institutions on subprime mortgages. Charles A.E. Goodhart and Dmitri Tsomocos, "Liquidity, Default, and Market Regulation," VoxEu (Nov. 12, 2009), *available at* http://www.voxeu.org/article/liquidity-default-and-market-regulation. It does not appear unreasonable to suggest that the institutions that were at the center of the financial crisis were both illiquid and insolvent.

6 Charles A.E. Goodhart, "Liquidity Risk Management," London School of Economics Markets Group Paper (Oct. 2007), *available at* http://www.lse.ac.uk/fmg/documents/specialPapers/2007/sp175.pdf.

7 *Id.* As mentioned, the line between "illiquidity" and "insolvency" is a difficult and dangerous one to draw. The mantra of central bankers is to "lend freely to solvent institutions, against good collateral and at penalty rates." But as Professor Goodhart points out, "Just as it is the métier of god to have mercy on sinners, however heinous the sin, so it is the métier of central banks to provide liquidity to systemic financial institutions, however dubious are the assets on their balance sheet." *Id.*

But simply being able to meet net cash outflows over a 30-day period is only the beginning of the inquiry: financial institutions also face risks arising from the significant maturity mismatches between their assets and their liabilities. Because one of the principle social purposes that financial institutions fulfill is to perform maturity transformation—that is, borrowing short-term funds and lending them back out at longer maturities—financial institutions face the risk that they may be called upon to pay back what they have borrowed before their borrowers have paid them back. The liquidity risk that financial institutions face from maturity mismatch is particularly acute because the households, businesses, and institutions that lend to financial institutions themselves have a strong preference for highly liquid claims against the financial institution at the same time that productive funding to the real economy requires committee funding for longer periods of time—in some cases multiple years. In short, an over-reliance on short-term funding makes financial institutions and the financial system extremely vulnerable to shocks, panics, and runs. As University of Chicago Business School Professor John Cochrane succinctly put it, "Short-term debt is the poison in the well."[8]

Financial institutions can address this mismatch in several ways. They can shorten the maturities of the assets they hold, which means that assets will mature as these institutions need cash to pay off their liabilities. In addition, assets with shorter maturities are generally more liquid, which further provides these institutions with greater liquidity. Financial institutions can lengthen the maturities of their liabilities—that is, they can fund themselves using longer-term loans that will mature beyond the time horizon of an actual or potential cash crunch. And financial institutions can fund themselves using more equity, which is equivalent to a bond with perpetual maturity.

But addressing this mismatch imposes costs on financial institutions. Shorter-term assets will typically pay less than longer-term assets, and longer-term liabilities cost more than shorter-term liabilities. As a result, financial institutions have an incentive to fund themselves using relatively cheaper short-term liabilities and to use the proceeds to invest in relatively higher-yielding assets. This profit-maximizing behavior, however, comes at the expense of the broader financial system and the economy as a whole: the mismatch between a financial institution's short-term liabilities and long-term assets exposes it to the risk of runs, effectively externalizing the cost of the firm's profit-seeking behavior on the broader economy, or it requires the central bank to subsidize the firm's profit seeking behavior by serving as a perpetual liquidity backstop—as Charles Goodhart succinctly put it, these firms are "taking out a liquidity 'put' on the Central Bank; they are in effect putting the downside of liquidity risk to the Central Bank."

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8 John H. Cochrane, "Equity Financed Banking and a Run-Free Financial System," Remarks at the Minneapolis Federal Reserve Bank's Second Symposium on Too Big to Fail (May 16, 2016), *available at* http://faculty.chicagobooth.edu/john.cochrane/research/papers/run-free_talk_mn_2016.pdf. Vanderbilt Law Professor Morgan Ricks has also emphasized the role that short-term debt and maturity mismatches play in destabilizing the financial system. *See, e.g.,* Morgan Ricks, *The Money Problem: Rethinking Financial Regulation* (2016) and "A Former Treasury Advisor on How to Really Fix Wall Street," *New Republic* (Dec. 17, 2011), *available at* https://newrepublic.com/article/98659/wall-street-term-out-panic.

The Proposed Rule forces financial institutions to internalize these costs and prevents them from placing a "liquidity put" on the central bank by placing limits on the extent to which financial institutions can rely on short-term funding to purchase long-term assets. The Proposed Rule does this by requiring financial institutions to maintain an "available amount of stable funding" ("ASF") greater than their "required amount of stable funding" ("RSF"). The amount of available stable funding is calculated according to the maturity of a financial institution's liabilities as well as the propensity and ability of the institution's creditors to withdraw their funding. The amount of required stable funding is calculated according to the liquidity-risk characteristics of the financial institution's assets and off-balance sheet activities. By requiring financial institutions to maintain an ASF greater than its RSF, the Proposed Rule will keep these institutions from over-relying on short-term funding and engaging in overly risky or excessive maturity transformation.

Recently, the Clearing House—a trade organization representing the nation's largest commercial banks—has argued that the NSFR is "conceptually redundant," essentially duplicating the Liquidity Coverage Ratio.[9] But Stephen Cecchetti, Dietrich Domanski, and Goet von Peter point out, the Liquidity Coverage Ratio and the NSFR "address different sources of liquidity problems":

> The [Liquidity Coverage Ratio] aims to protect a bank against the inability to meet its short-term payment obligations because many assets cannot be liquidated under adverse market conditions. The longer-term NSFR limits maturity transformation. Both requirements are complementary as funding problems and illiquid markets typically coincide in a crisis.[10]

In other words, the NSFR is not "redundant": it is an essential complement to the Liquidity Coverage Ratio, focused on a different liquidity risk that affects large financial institutions—the risk arising from maturity transformation and maturity mismatches.

The Clearing House's objections should also be viewed in the context of the cost-benefit analysis that the Agencies described in their Proposed Rule. As the Agencies noted in their "Analysis of Proposed Benefits," if the Proposed Rule "reduces the probability of a financial crisis even slightly, then the benefits of avoiding the costs of a crisis . . . would outweigh the relatively modest aggregate cost of the rule." Better Markets commends the Agencies for correctly weighting the relative benefits and costs of the Proposed Rule: the costs that are most relevant for this determination are not the costs to the financial institutions of complying with the Proposed Rule or the costs of a decline in economic output. Instead, the proper costs for evaluating the benefits of the Proposed Rule are the costs of the financial crises avoided. Better Markets has calculated the costs of the 2008 Financial Crisis

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9 The Clearing House, "The Net Stable Funding Ratio: Neither Necessary nor Harmless" (July 2016), *available at* https://www.theclearinghouse.org/~/media/TCH/Documents/20160705_TCH_NSFR_Note.pdf.

10 Stephen G. Cecchetti, Dietrich Domanski, and Goetz von Peter, "New Regulation and the New World of Global Banking," *National Institute Economic Review* (April 2011), *available at* http://people.brandeis.edu/~cecchett/Jpdf/J41.pdf.

as greater than $20 trillion.[11] Put differently, the 2008 Financial Crisis was the most expensive cost-benefit analysis conducted in the history of the world. Ensuring that financial institutions do not engage in risky and dangerous maturity transformation that leave them vulnerable to runs and panics is a small price to pay for avoiding another such calamity.

The Agencies should require institutions to report information about their liquidity profiles more frequently than once a quarter.

Financial institutions, market participants, and regulators frequently underestimate or misunderstand the liquidity risks that large, complex financial institutions take in managing balance sheets that total in the hundreds of billions or trillions of dollars. These risks can change quickly, leaving creditors and counterparties blindsided when asset prices change suddenly and liquidity disappears. As economists at the International Monetary Fund put it,

> [T]he liquidity properties of assets and liabilities can change abruptly during crisis periods; information amplifiers may render illiquid assets that are normally close substitutes for cash, or subject even notionally long-term liabilities to "runs."[12]

It is precisely because the liquidity position of a firm can change so quickly that the Agencies should require more frequent disclosure. Given the frequency and speed with which financial institutions can change their positions, a firm's liquidity profile could change significantly over the course of a single day. As a result, requiring quarterly disclosure all but guarantees that the information being provided to market participants, creditors, and counterparties will be stale and of little use to them in managing risk or pricing credit. Quarterly disclosure gives creditors and counterparties the data they would have needed to price for risk one, two, or three months earlier—not the data they need to price for risk at the time they are extending credit or entering into transactions with a large, complex financial institution.

The most effective way to ensure that the disclosure of the NSFR meets the needs of transparency and market discipline would be to require large, complex financial institutions to disclose their liquidity profiles on a daily basis.[13] More frequent disclosure would not be destabilizing. Instead, it is quarterly disclosure that would be destabilizing: rather than being able to adjust to daily incremental changes in a covered institution's liquidity position,

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[11] *See* Better Markets, *The Cost of the Crisis: $20 Trillion and Counting* (2015), *available at* https://www.bettermarkets.com/sites/default/files/Better%20Markets%20-%20Cost%20of%20the%20Crisis.pdf.

[12] Daniel C. Hardy and Philipp Hochreiter, "A Simple Macroprudential Liquidity Buffer," IMF Working Paper (Dec. 2014), *available at* https://www.imf.org/external/pubs/ft/wp/2014/wp14235.pdf.

[13] Better Markets has made this point before, in its comments on Basel Committee on Banking Supervision's Proposed "Net Stable Funding Ratio Disclosure Standards." *See* Better Markets letter to the Basel Committee on Banking Supervision, re: Net Stable Funding Ratio Disclosure Standards, December 2014 (March 6, 2015), *available at* https://www.bettermarkets.com/sites/default/files/documents/BCBS-%20CL-%20Net%20Stable%20Funding%20Ratio%20Disclosure%20Standards%203-6-2015.pdf, incorporated as if fully set forth herein.

market participants, creditors, and counter-parties would instead find themselves responding to disclosures of large changes in an institution's liquidity profile since its last quarterly disclosure. As a result, market participants, creditors, and counterparties will be on a quarterly hair trigger, requiring them to react precipitately to any change in a firm's liquidity profile. And in between quarterly disclosures, market participants would be left to react to rumors and speculation about a firm's liquidity profile, which would in turn require them to defensively position themselves in response to what they believed but did not know about an institution's liquidity.

If the Agencies required more frequent disclosure, market participants could react more often to changes that are likely to be smaller and more gradual, rather than reacting once every three months to changes in liquidity profiles that are more likely to be sharp and discontinuous. If the Agencies' goal is to provide transparency and enhance market discipline without destabilizing companies or roiling financial markets, more frequent disclosure would better serve the Agencies in achieving these goals.

Not only would more frequent disclosure provide greater transparency to market participants and enhance market discipline, more frequent disclosure would also make it harder for large financial institutions to game the NSFR disclosure requirements. As the financial economists Douglas Diamond and Anil Kashyap have shown, allowing banks to disclose their liquidity profiles periodically—rather than requiring constant disclosure—can pose "the temptation for banks to engage in window dressing of their accounting information . . . this possibility for window dressing implies that liquidity disclosures and regulations should hold on all dates rather than being applied periodically."[14] Given the potential for significant stock swings from these quarterly disclosures, this temptation will be difficult to resist. To prevent the temptation that Diamond and Kashyap identified—the temptation to engage in accounting-driven transactions just before the quarter ends to make their liquidity profiles appear better than they normally are—the Agencies should require disclosure more frequently than the quarterly disclosure contemplated in the Proposed Rule.

CONCLUSION

Better Markets strongly supports the goals that underlie the Proposed Rule: large complex financial institutions should be forced to internalize the costs of the liquidity they consume in periods of economic stress. The Liquidity Coverage Ratio ensures that these institutions will have the liquidity on hand that they will need to meet their funding requirements over the short term during times of severe economic stress. The NSFR complements and completes this much needed requirement by addressing the maturity mismatch between the long-term assets and short-term liabilities that the world's largest financial institutions hold on their balance sheets. As a result, these institutions will be better able to withstand drops in asset values by reducing the severity of their funding needs.

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[14] Douglas W. Diamond and Anil K. Kashyap, "Liquidity requirements, liquidity choice and financial stability" (December 2015), *available at* http://faculty.chicagobooth.edu/anil.kashyap/research/papers/dkconferencedraft%20November%2020.pdf.

Nonetheless, the Proposed Rule should be made stronger and more effective by requiring these institutions to disclose their NSFR profiles more frequently than once a quarter.

We hope these comments are helpful to the Agencies as they continue their work to ensure that the world's largest financial institutions and the global financial markets remain strong and resilient.

Sincerely,

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