THE FINANCIAL SERVICES ROUNDTABLE

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Via E-Mail

April 16, 2010

Secretariat of the Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002
Basel, Switzerland

Re: Consultative Document: *International Framework for liquidity risk measurement, standards and monitoring*

Dear Sir or Madam:

The Financial Services Roundtable[1] appreciates your invitation to comment on the Basel Committee's Consultative Document proposing an international framework for liquidity risk measurement, standards, and monitoring. We agree that the recent disruption in financial markets demonstrates the need for improvements in liquidity management and standards. We also support the general concept of a quantitative regime for liquidity purposes. However, we are very much concerned that the details of the approach outlined in the Consultative Document will have significant unintended consequences, especially in light of the numerous other proposals issued by the Basel Committee, as well as by national regulators, accounting standards setting bodies, and the United States Congress. By itself, the calibration of assumptions contained in the Consultative Document is so conservative and risk adverse that it will harm the banking sector more than help it. Further, the impact of the proposal as currently constituted will be to significantly inhibit financial firms in their traditional role of intermediary and maturity transformation and hinder the flow of funding and capital to the private sector.

As a general matter, the liquidity proposal utilizes extreme, stressed scenarios that will result in excessive liquidity requirements. Excessive liquidity will decrease credit availability and reduce bank profitability. It will negatively impact the ability of financial companies to attract private capital, and will reduce the ability of banks to provide the necessary funds for vibrant and healthy economic growth. Some institutions will be tempted to engage in riskier lending activities in order to recapture the lost income resulting from holding low yielding liquidity assets. This will decrease, rather than increase, overall safety and soundness.

[1] The Financial Services Roundtable represents 100 of the largest integrated financial services companies providing banking, insurance, and investment products and services to the American consumer. Member companies participate through the Chief Executive Officer and other senior executives nominated by the CEO. Roundtable member companies provide fuel for America's economic engine, accounting directly for $74.7 trillion in managed assets, $1.1 trillion in revenue, and 2.3 million jobs.

Further, unless the flood of proposed regulatory changes are coordinated among all of the regulatory bodies, the aggregate effect of these developments will be to unnecessarily impede economic growth, reduce the viability and competitiveness of regulated financial institutions, and motivate the surviving depository institutions to engage in riskier activities. As a result, unregulated or lightly regulated institutions will take over much of the financial intermediation functions currently provided by depository institutions, and the safety and soundness of regulated companies will deteriorate rather than improve.

The Liquidity Coverage Ratio Proposal

The Consultative Document proposes two quantitative liquidity standards. The first quantitative measure, the "Liquidity Coverage Ratio," relates to the amount of high quality, unencumbered liquid assets a banking organization should have at hand in the event of a liquidity crisis that lasts for 30 days. The stress scenario suggested in the proposal would assume that: (i) the bank suffers a significant credit rating downgrade; (ii) the bank has a partial loss of retail deposits; (iii) the bank loses unsecured wholesale funding; (iv) there is a significant increase in secured funding haircuts; and (v) the bank is faced with an increase in derivative collateral calls, funding demands from credit and liquidity facilities, and other off-balance sheet exposures. As part of this framework, the regulators are to assume the loss of both *secured* and unsecured funding.

Under the proposal, a bank must have liquid assets that would equal or exceed the run-off in funds under the stressed scenario. Qualified liquidity assets must be easily and immediately converted into cash with little loss of value. The assets must be "unencumbered," meaning that they have not been pledged in any way to secure, collateralize, or enhance any transaction (other than assets that have been pledged to the *Federal Reserve* but not utilized). Further, the assets cannot be held as a hedge against another exposure.

Under this proposed standard, banking organizations would be required to hold a narrow range of extremely liquid, highly creditworthy assets that generally would both be eligible for discount with a lender of last resort and be liquid in public markets. These assets would either produce no return or a very low return. As a consequence, banking organizations would have to invest their remaining assets in higher yielding and riskier assets in order achieve the earnings necessary to attract capital. Thus, unless the range of assets qualified to meet this liquidity test is broadened, the test will have the unintended consequence of increasing the overall risk of depository institutions or reducing their profitability and thus their viability.

The proposal notes that the Basel Committee is considering whether other instruments can be used to satisfy this test, but would subject these assets to a haircut, even if the assets, such as investment grade corporate bonds, could be pledged as collateral to secure Federal Reserve Bank loans. In addition, these other assets could not compose more than 50 percent of the mandated liquidity base. We question whether the severe haircuts for assets such as covered bonds and high quality corporate debt are justified by historical experience. More broadly, we urge that the Committee expand the range of eligible liquidity assets to provide the flexibility necessary for regulated institutions to meet this standard without holding excessive amounts of cash and other low yielding assets. Severely limiting the choice of instruments to make up the

liquidity buffer may be contradictory to the Committee's purpose of minimizing liquidity risk by diversifying funding sources and will lead to distortions in the markets. A narrow definition of these assets may lead to similar circumstances to the current crisis where concentrations resulted in sellers but no buyers for certain asset classes.

In addition, we note that the proposal does not recognize the liquidity benefits provided by the Federal Home Loan Banks and other lenders of last resort (except for the Federal Reserve). In the United States, facilities such as the Federal Home Loan Banks have demonstrated their ability to provide liquidity during periods of extreme stress in the mortgage markets. Available committed lines of credit with the Federal Home Loan Banks and similar entities should be recognized in the revised proposal.

Net Stable Funding Ratio

The second new quantitative test proposed in the Consultative Document is the "Net Stable Funding Ratio." This standard attempts to measure the sufficiency of a bank's long-term stable funding relative to the potential calls on the bank's resources, including calls from off-balance sheet exposures. The bank's long term liquidity needs are measured by assuming a stress scenario, *e.g.*, a significant decline in the bank's profitability, a potential downgrade by a credit rating agency, or an event that calls into question the bank's reputation or credit quality of the institution.

A bank's "available stable funding" is defined as the total amount of the institution's: (i) capital; (ii) preferred stock with a remaining maturity of one year or longer; (iii) liabilities with remaining maturities of one year or longer; and (iv) stable deposits that would not be withdrawn even during a stressed environment. National regulators are to apply different haircuts to a source of funds depending upon such factors as the existence and extent of deposit insurance protection. However, no liquidity credit is given for access to either the Federal Reserve or Federal Home Loan Bank borrowing facilities.

The amount of stable funding required is determined by assigning assets (and off-balance sheet exposures) a particular "required stable funding" ("RSF") factor. The more liquid the asset, the lower the RSF factor.

All encumbered assets (other than assets involved in a repurchase transaction) are assigned an RSF factor of 100 percent. Marketable securities with a maturity of one year or less, a credit rating of AA, and for which an active repurchase market exists, are assigned an RSF of 5 percent. Corporate bonds and covered bonds with a maturity greater than one year are assigned an RSF of 20 percent.

For off-balance sheet items, the RSF factor will depend on the extent that the exposure is acting as a credit or liquidity facility, or would otherwise require funding by the bank. The proposal gives each country's regulators considerable discretion but enumerates a list of off-balance sheet items for which an RSF should be assigned. This list includes unconditionally revocable uncommitted credit and liquidity facilities, guarantees, letters of credit, structured

products, money market funds, and potential requests to repurchase assets sold into a securitization or other funding vehicle.

As currently calibrated, the degree of stress under the NSFR and the LCR are not adequately differentiated. We believe that the net stable funding ratio standard should be designed to reflect more normal market conditions, rather than the highly stressed scenario described in the proposal. The liquidity coverage standard will ensure that covered institutions will have sufficient liquidity to survive a highly stressed period. The stable funding standard should be designed to ensure that an appropriate portion of a bank's funding is from longer-term instruments during more normal market times Concerns about a stressed environment should be addressed in the liquidity coverage standard.

Further, the proposal fails to include the fact that Federal Home Loan Bank borrowings can extend longer-term loans, especially if necessary due to liquidity, rather than credit, problems. Excluding consideration of the Federal Home Loan Bank facilities distorts the standard, and will result in unnecessary constraints on funding flexibility.

<u>Other Comments</u>

Deposit runoff assumptions in the NSFR and LCR are overly aggressive and not supported by empirical data. We are particularly concerned about the degree of deposit runoff assumed for corporate deposits and deposits from financial institutions which have operational or transactional accounts and well established relationships. Experience in the crisis shows that substantial financial institution and other institutional deposits continued to provide liquidity due to strong underling business relationships. Substantial portions of such deposits are associated with a pattern of "core" business, often including payments, custodial, and securities-settlement accounts, and other types of business. In addition, we believe that consumer deposits that are fully covered by governmental insurance, such as the FDIC insurance program in the United States, should be presumed to be stable, especially if these deposits are not "brokered" deposits or internet based deposits.

The Basel Committee's proposed framework also does not distinguish between deposits held by custodian banks on behalf of their institutional clients and general sources of wholesale funding. This results in the imposition of a punitive run-off rate of 100%, a figure vastly at odds with both the stable, long-term nature of custodial deposits and the experience of the custody industry during the financial crisis. We therefore recommend that the Basel Committee amend its approach so that custodial deposits are treated in the same manner as operational deposits from certain non-financial institutions, such as corporate and public sector entities. [This would imply an LCR run-off rate no greater than of 25% and an NSFR factor of 70%.]

We understand that the Committee is concerned that banks may not be able to access all of the liquidity lines that they may have established prior to a significant liquidity event. However, the approach taken in the proposal, to totally disregard lines of credit and other contractual sources of liquidity, appears unnecessarily draconian.

We believe that banks should be given liquidity credit for legally enforceable agreements with creditworthy third parties that are unconditional enforceable by the bank, and are not dependent on the financial condition of the bank at the time of the draw. To the extent that a bank has such contractual relationships with a well diversified group of strong counterparties, the amount of liquidity credit should be increased. As a policy matter, such arrangements are consistent with safety and soundness and appropriate risk management, and should be encouraged.

We also note that under the proposal, when a bank will be assumed to fully fund all of its liquidity funding responsibilities with other entities, it will have to assume that none of its liquidity providers will fulfill their obligations. It seems overly punitive to assume both that the bank will fully fund its obligations, but assume that all other institutions will default on similar contractual relationships. A better assumption would be that at least some subset of liquidity providers would comply with their contractual obligations to provide the called for funds to the banking institution, and that different types of counterparties would have varying liquidity needs, and not all would draw down their credit lines.

Leverage finance, syndications, bridge facilities may be more likely to be affected by financial disruption, and more likely to be drawn, based on experience from the crisis. Other types of lines did not see any appreciable increase in draws. The crisis has shown that financial institutions deleverage in time of liquidity crisis, and corporate clients stop their investment programs. For example, mutual funds and other registered investments funds simply do not exhibit the same liquidity profile. These behavioral facts should be taken into account in an appropriately conservative manner. A 100 percent assumption for financial institutions should be lowered, and the Committee should consider a more granular approach as this proposal is further refined.

We also question the treatment of intra-company liquidity commitments. Liquidity support arrangements by different subsidiaries within a holding company do not affect the overall liquidity position of the holding company. However, under the proposal, liquidity will be effectively trapped in some of the companies, even though there would be sufficient liquidity in the entity as a whole. We believe that this anomaly needs to be addressed.

To the extent that the Committee has concerns with lines of credit and other liquidity facilities, we believe that an appropriate discount could be applied. The discount could be determined with input from national supervisory authorities, based on their experience from the recent liquidity events. This would be a more measured approach that would also be more consistent with the policy goals of encouraging risk planning and back up liquidity support.

The experience of the crisis was that the repo markets remained very active for a far wider scope of securities than the eligible-assets category defined by the current proposal. During recent stress events secured financing utilization was not significantly impacted for U.S. or European Investment Grade Corporates, U.S. or European Equities, U.S. Convertible Debt (Investment Grade) and Private Label CMOs (Investment Grade). Financing utilization decreased for certain assets, including U.S. High Yield Corporate Debt, Private Label CMOs (Non-Investment Grade), Convertible Debt (Non-Investment Grade), Emerging Markets and

High Yield Equity Securities and Emerging Markets Sovereign Debt. Instead of assuming 0% liquidity, using assumptions based on stress haircuts experienced during the 2007-2009 period would ensure that enough conservatism is built into the measure. Further, we are concerned about the asymmetric treatment of repos and reverses and securities lending and borrowing. The current treatment assumes that borrowings are repaid contractually, but that cash placed with counterparties is not repaid. In reality, in a scenario where secured borrowing is limited, treasurers and finance desks will also be recalling cash.

Complete run-off of wholesale market-based funding is unrealistic, except in case of an actual bank failure. During the most recent crisis, wholesale funding markets remained available, albeit at shorter maturities. During all but the most acute part of the crisis, much of the funding described as "wholesale" was available to adjust funding levels. To create incentives for interbank funding, an appropriate amount of market funding shorter than a year should be eligible to be counted as stable funding.

The current proposal assumes total loss of funding on maturing term securitizations and ABCP. This reduces incentives for securitization of assets and for increasing the flow of liquidity to segments of the market and potentially reduces economic activity. Similarly, the limited recognition of secured funding capability to only the most highly rated collateral is contrary to the experience during the recent crisis. The collateral types should be expanded with appropriate haircuts.

Under the proposed NSF standard, a banking organization that matches a longer term asset with a bond with the same maturity will be penalized in the year that both the asset and the bond mature, even though these instruments are perfectly matched. This because the bond will have an effective maturity of less than one year when it reaches its final year, and the bank will not be able to count it as a long-term stable asset. However, since the asset will also mature at the same time, the result is to penalize the bank for matching its positions. We believe that the standard should disregard perfectly matched positions to avoid this result.

As currently drafted, the Basel Committee's framework does not provide banks with credit for scheduled amortizations and expected pre-payments on pooled investment securities with terms to maturity greater than one year. As a result, banks are required to fund these stable and predictable inflows of cash with long term funding. We believe that this is an unnecessarily rigid approach which overlooks both the structure and observed behavior of many pooled investment securities, including agency sponsored MBS. We therefore recommend that the Basel Committee adjust its liquidity framework so that scheduled amortizations and expected pre-payments on pooled investment securities, as derived from internal modeling, are included within the category of assets with a 0% required stable funding factor

Conclusion

The Financial Services Roundtable appreciates the need to have adequate liquidity in our financial system, and the need for uniform and objective standards, including a quantitative standard. We support a Basel approach for a single set of global liquidity standards that supersede local requirements. This addresses concerns about a patchwork of country-specific

liquidity regimes and reporting requirements that may be devastating to the business models of global financial organisations. This is consistent with the directives of the G-20 which emphasize the need to develop global standards through the Basel process However; we believe that the proposal, in its current form, will actually increase the risk in the U.S. banking system by mandating unnecessarily stringent and conservative standards.

We urge the Basel Committee to carefully consider the impact of other on-going efforts with respect to capital, liquidity, accounting standards, and other prudential rule changes. The need for high levels of liquidity will obviously be modified if these other changes are implemented. Further, the Committee must be mindful of the cumulative effect of all of these developments. Economic growth and the safety and soundness of the financial system depend on reasonable regulations and requirements. Public policy will not be furthered if potential private investors in financial firms determine that the likely returns are not sufficient or if regulated institutions are forced to make riskier investments to offset the lost earnings that result from outsized liquidity or capital mandates.

While we support a Basel approach for a single set of global liquidity standards as part of that process, we are concerned that over reliance on such quantitative measures may not result in standards that are truly comparable across national borders due to intrinsic differences in business relationships, contractual rights, and the existence of implicit or explicit governmental guarantees and support. Further, the public misrepresentation of the liquidity risks and positions would be potentially damaging to firms and the industry. Therefore, we recommend that the Basel Committee also rely heavily on a Pillar 2 supervisory review and market pressures to achieve the necessary improvements in liquidity risk management.

We have raised a number of specific issues in this letter and hope that the Committee will consider these points and suggested changes as it continues its deliberative process to formulate international liquidity standards.

In this regard, we strongly urge the Committee to publish a revised Consultative Document on liquidity, and provide another opportunity for public comment. The issues raised by this proposal, and the potential impact on the world's economy, are simply too important and too complicated to rush through without an adequate opportunity for further public review and comment and the proposal is further refined.

We thank you again for this opportunity to comment on the Consultative Document. If you have any questions, please contact me at (202) 289-4322.

Sincerely,

Richard M. Whiting

Richard Whiting
Executive Director