American Bankers Association
Building Success. Together.

Alison Touhey
Vice President &
Senior Regulatory Advisor
202-663-5182
atouhey@aba.com

October 1, 2018

Submitted electronically

Legislative and Regulatory Activities Division
Office of the Comptroller of the Currency
400 7th Street, SW Suite 3E-218,
Mail Stop 9W-11 Washington, DC 20219

Ms. Ann E. Misback,
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW Washington, DC 20551

Mr. Robert E. Feldman,
Executive Secretary
Federal Deposit Insurance Corporation
550 17th Street, NW Washington, DC 20429

Re: Liquidity Coverage Ratio Rule: Treatment of Certain Municipal Obligations as High-Quality Liquid Assets

Ladies and Gentlemen:

The American Bankers Association (ABA)[1] appreciates the opportunity to comment on the interim final rule issued by the Office of the Comptroller of the Currency, the Federal Reserve Board, and the Federal Deposit Insurance Corporation (FDIC) (together, the agencies) to amend the liquidity coverage ratio (LCR) to treat certain municipal securities as high quality liquid assets (HQLA). This change is being undertaken as required under the Economic Growth, Regulatory Relief, and Consumer Protection Act of 2018 (EGRRCPA).

ABA supports the proposal and commends the agencies for recognizing both the high quality nature of municipal securities and that asset classes not originally specified in the LCR rule may be suitable for HQLA eligibility. Banks are important investors in the municipal markets and understand their value. Encouraging investment in municipal securities will make funding for state and local entities more accessible and less expensive, while expanding the supply of HQLA. We agree with the Agency's statement in the preamble that by expanding the band of assets considered HQLA eligible, "covered companies will have greater flexibility on meeting

---

[1] *The American Bankers Association is the voice of the nation's $17 trillion banking industry, which is composed of small, regional, and large banks that together employ more than 2 million people, safeguard $13 trillion in deposits, and extend nearly $10 trillion in loans. Learn more at* aba.com

the minimum requirements under the LCR rule as more types of assets will be eligible as HQLA".[2] We would add that widening the list of HQLA eligible assets also benefits U.S. markets and bank customers.

Regarding the LCR more broadly, as we have noted in multiple comment letters, congressional testimony, and a white paper, the existing LCR regulations do not sufficiently embrace the actual breadth and depth of liquidity in the U.S. economy. The current rules also fail to reflect the business practices of banks or their funding and liquidity management processes. In order to improve the calibration of the LCR and prevent unnecessary market distortions, we recommend that the agencies revisit both the scope of assets recognized as HQLA and the stability assumptions assigned to various products and services, funding sources, and operational line items.

The LCR touches almost every aspect of a bank's balance sheet with a static approach that hardwires assumptions about asset liquidity and the sources and uses of available funding. Getting liquidity regulation right, then, is important for local, state, and national economic growth, because liquidity affects both the amount of financial services banks can provide and the form that those services take.

To avoid unintended market distortions the LCR should be revised to reflect U.S. market liquidity and bank liquidity risk more accurately.

ABA believes the list of eligible assets in the LCR rule can be broadened to reflect the depth and breadth of high quality assets available in the U.S., assisting rather than compromising liquidity risk management at covered institutions. Increasing the types of assets allowed into the definition of HQLA will diversify bank holdings, while permitting banks to create an HQLA portfolio that allows them to comply with the LCR and matches their individual business model. Expanding the definition of HQLA would also mitigate the risks posed by codifying the herding of liquidity within the financial system into an extremely narrow band of assets during a time of stress.

As ABA has noted on many previous occasions,[3] because the LCR requires banks to concentrate holdings in a static and narrowly defined list of assets, it is excessively pro-cyclical, likely to hasten and deepen a recession. The narrow band of allowable HQLA will cause market participants to hoard qualifying assets, feeding market distortions during times of stress as eligible assets will become exceedingly expensive and hard to obtain. Moreover, discouraging bank investment in debt securities other than Treasuries decreases daily operating liquidity in unfavored markets, such as those for corporate debt, among others.

Additionally, we urge the agencies to review the LCR's assumed outflows. The amount of HQLA that banks are required to hold is assessed relative to the amount of funding assumed to

---

[3] ABA comment letter on the Liquidity Coverage Ratio
https://www.aba.com/Advocacy/commentletters/Documents/13114-ABA-LCR.pdf
ABA white paper on the Basel III Liquidity Standards:
https://www.aba.com/Advocacy/LetterstoCongress/Documents/LiquidityReport-ABA-March2017.pdf

leave the bank in a period of idiosyncratic or systemic stress. Estimated outflows in the LCR rule should reflect relevant factors that drive the behavior of bank counterparties. Accurate run-off rates are particularly important given that the LCR's funding hierarchy incentivizes the holding of specific deposits and discourages others, causing banks to reduce significantly the extension of products and services that are treated punitively in the LCR calculation. For example, corporate and municipal deposits are disfavored by the LCR, increasing the cost to banks—and thus to bank customers—for banks to hold them. Such costs would become more acute in times of financial stress, when banks would be required to find proportionately more HQLA to offset such deposits precisely when supplies of HQLA would become harder to find and investors would be increasingly anxious to place their deposits in banks as safe havens.

As a consequence of the LCR rule, some banks would be placed in the predicament of having to choose between refusing deposits and/or charging some businesses fees for holding large deposits. This constraint disproportionally affects state and municipal deposits, those from non-financial companies, and deposits from non-regulated funds since under the LCR their deposits are among the most harshly treated. Conversely, the limited deposits favored by the LCR, such as retail deposits, are attracting increasing competition—artificially increasing costs to the banking industry overall and community banks specifically.

Of major importance to any regulatory framework is ensuring that its requirements are properly calibrated, targeting the variety of risks that the framework intends to mitigate. This includes properly defining various products and services, recognizing their liquidity risks or value, and making rational assumptions about market realities of both banks and their counterparties—conditions that are far less static than assumed in the LCR regulations. As highlighted below, there are several items in need of technical cleanup, as they are either incorrect or not accounted for under the current rule.

Retail trusts should be treated as natural persons.

As we noted in our letter in response to the proposed rules to implement the Basel-developed Net Stable Funding Ratio (NSFR),[4] the treatment of retail trusts in the LCR rule does not align well with the nature or behavior of deposits. Section 3 of the LCR defines a "retail customer or counterparty" as an individual or business customer that meets specific criteria. When finalizing the LCR, the agencies recognized that certain trusts exhibit the same behavior as a retail depositor and may be the "alter ego" of the grantor.[5] However, the regulation so narrowly defines retail trusts that it excludes common trust arrangements that are also akin to a natural person. As a result, many deposits made on behalf of trusts are improperly subject to wholesale treatment.

[4] ABA letter on NSFR: https://www.aba.com/Advocacy/LetterstoCongress/Documents/LiquidityReport-ABA-March2017.pdf.

[5] 79 Fed. Reg. 61440, 61482 (October 10, 2014).

Section 3 of the LCR offers as a definition of retail living or testamentary trust that it—

> (i) Is solely for the benefit of natural persons;
> (ii) Does not have a corporate trustee; and
> (iii) Terminates within 21 years and 10 months after the death of grantors or beneficiaries of the trust living on the effective date of the trust or within 25 years, if applicable under state law.

ABA proposes that this definition be revised to read as follows:

> (3) A living or testamentary trust with a natural person as trustee or a natural person who has the power to revoke the trust, remove the trustee, or direct the trustee.

Our proposed language addresses both the agencies' concerns (1) with trusts that behave like institutions, and (2) that certain personal trusts that do not meet the existing definition are nonetheless similar to retail depositors and should be treated as such.

The rationale for our recommended approach follows closely with the reasoning in the Securities and Exchange Commission's (SEC) money market mutual fund reforms.[6] The SEC, similarly concerned with liquidity of regulated prime money market funds, created a new category of fund limited to "retail investors." The test for a retail investor requires that a natural person have "investment power" over the security, which includes "the power to dispose, or to direct the disposition of, such security."[7] Hence a revocable trust, even with a corporate trustee and with non-natural beneficiaries such as schools and charitable entities, may invest in a retail fund. The account is considered as retail, because the grantor or other natural person, who has the ability to revoke the trust, has "investment power." Similarly, if an irrevocable trust has two co-trustees, one being corporate and the other a natural person, the account still may be deemed "retail," because the natural person co-trustee has "investment power."

We believe that the SEC's framework for determining a retail investor works equally well with respect to differentiating trusts as retail depositors. The question should not be whether the trust has a corporate trustee or charitable beneficiaries, but whether a natural person has the ability to make decisions about the deposit account, for example as a co-trustee, a grantor of a revocable trust, or as a trust director with investment authority.

The LCR should reflect the market realities of bank counterparties, among other needed technical corrections.

The current LCR framework does not accurately capture the market realities of many bank counterparties. For example, the treatment of commitments does not account for the differences in drawdown rates for counterparties with different credit quality. During a period of market stress, investment grade counterparties will have greater access to funding than will high yield counterparties, so that higher yield counterparties will likely draw down their commitments at a

[6] 15 CFR 270.2a–7.
[7] See OCC Bulletin 2016-17 for a good summary of the reforms.

higher rate. This difference is not reflected in the LCR.

Moreover, maturity assumptions are not aligned with realistic market practices in stress. For example, a rational firm would not exercise the option to reduce the maturity of a repo during a liquidity stress, as assumed under the LCR. Another example is the silence of the LCR on the maturity date of retail loans. Under the rule, the maturity date of transactions that are considered secured lending transactions is assumed "to be the first calendar day after the calculation date".

However, the LCR does not include specific maturity assumptions for retail cash inflow amounts. In the absence of an inflow category-specific maturity assumption, the LCR requires banking organizations to assume that the transaction matures "on the latest possible contractual maturity date or the latest possible date the transaction could occur, taking into account any option that could extend the maturity date or the date of the transaction." Thus, open retail demand loans do not receive inflow under LCR.

Under the current LCR rule, deposit balances that result from the provision of custody services to a non-regulated fund are automatically excluded from categorization as an operational deposit. This restriction is specific to the U.S. and has been implemented by the agencies alongside the exclusion in the Basel III liquidity framework for deposit balances that result from the provision of prime brokerage services. Custody services, which center on the provision of access to the global settlement infrastructure, various asset administration services, and the provision of deposit accounts used to facilitate day-to-day transactional services, are entirely distinct from prime brokerage services, which seek both to finance and facilitate client trading activity. The agencies approach is therefore unnecessary to achieve the LCR's objective, and it creates broad disincentives for non-regulated funds to make use of a custodian bank to safe-keep their assets, undermining rather than enhancing financial stability. We urge the agencies to use consideration of the interim final rule to correct the 'gold-plated' treatment of operational deposits from non-regulated funds in the LCR rule.

Other technical clean-up items that would allow the LCR to reflect liquidity risk more accurately include recognizing contractual substitution rights as a mitigant for liquidity risk, and also deposit insurance regimes outside of the United States.

There should be additional tailoring of the LCR based on risk profile and business model.

We support the recognition by Federal Reserve Vice Chairman for Supervision Randal Quarles that implementation of the LCR can be, and should be, better tailored to reflect the material differences in risk profiles, activities, complexity, and other relevant risk factors across large banking organizations under the Federal Reserve's broader initiative to revise its framework "to allow for a greater differentiation in the supervision and regulation of large firms."[8] We

[8] See Randal K. Quarles, Vice Chairman for Supervision, Board of Governors of the Federal Reserve System, *Early Observations on Improving the Effectiveness of Post-Crisis Regulation*, Remarks at the American Bar Association Banking Law Committee Annual Meeting (Jan. 19, 2018) ("T]he full liquidity coverage ratio (LCR) requirement and internal stress testing requirements of enhanced prudential standards apply to large, non-GSIB banks in the same way that they apply to G-SIB banks. I believe it is time to take concrete steps towards calibrating liquidity requirements differently for non-GSIB banks than for G-SIBs.") available at https://www.federalreserve.gov/newsevents/speech/quarles20180119a.htm.

encourage the agencies to move forward jointly and expeditiously in re-calibrating the LCR to reflect better the differing risk profiles and business models of the banking organizations subject to the so-called "Full LCR," consistent with the direction of Congress in the EGRRPCA that prudential regulations must be appropriately tailored to the risk and business model of covered organizations. Additionally, we urge the agencies to use the opportunity of finalizing the interim final rule to eliminate the use of static, arbitrary thresholds, such as the $250 billion asset and the $10 billion foreign exposure thresholds, for determining the scope of the of the "Full LCR."

Public disclosure of liquidity information can raise risks.

We urge the Agencies either to remove or increase the lag time associated with LCR disclosures. We remain concerned that the disclosures are too granular, which presents real risk under circumstances of idiosyncratic or systemic stress.

*****

Over the past eight years, the banking industry has worked hard to make liquidity risk monitoring and mitigation significantly more robust—making both individual banks and the system as a whole more resilient.

We appreciate your consideration of these comments and would welcome the opportunity to discuss them further. If you have any question or need further information, please contact the undersigned at 202-663-5182 or atouhey@aba.com.

Sincerely,

Alison Touhey
Vice President and Senior Regulatory Advisor