

Liquidity

**Basel III Liquidity Standards:
Changes Needed to Address Destabilizing Effects of Current Rules**



American
Bankers
Association®

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The Core Principles for Regulating the United States Financial System, enumerated in Executive Order 13772, include the following that are particularly relevant to an evaluation of current U.S. financial liquidity rules:

(c) foster economic growth and vibrant financial markets through more rigorous regulatory impact analysis that addresses systemic risk and market failures, such as moral hazard and information asymmetry;

(e) advance American interests in international financial regulatory negotiations and meetings;

(f) make regulation efficient, effective, and appropriately tailored; and

(g) restore public accountability within Federal financial regulatory agencies and rationalize the Federal financial regulatory framework.

The American Bankers Association¹ offers these views to the Secretary of the Treasury in relation to the Directive that he has received under Section 2 of the Executive Order.

- **Liquidity is an essential element of successful bank management and supervision.**
- **Basel global liquidity standards, as applied in U.S. regulations, have serious flaws that act to undermine stability of the financial system: U.S. regulations need revision so that they comport with U.S financial experience.**
- **HQLA is too narrowly defined, fostering the risk of destabilizing liquidity shortages in times of financial stress: it needs to be broadened.**
- **The LCR imposes a static structure on supervision of the dynamic reality of liquidity management: a more dynamic approach is needed.**
- **The NSFR is duplicative and out of date: it should be withdrawn.**

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 more than \$9 trillion in loans.

Prudent and effective management of liquidity risk is a fundamental aspect of bank safety and soundness. In response to liquidity stresses seen in 2007-2009, both at individual institutions and in overall funding markets, the G20 directed the Basel Committee on Banking Supervision (BCBS) to create and implement quantitative liquidity standards for globally active firms. Subsequently, as part of the Basel III reform package, the BCBS issued two quantitative liquidity standards: the Liquidity Coverage Ratio (LCR) and the Net Stable Funding Ratio (NSFR). The LCR, which was finalized by the U.S. regulators in October 2014, requires affected banks to hold a level of High Quality Liquid Assets (HQLA) sufficient to withstand a short-term stress. The Net Stable Funding Ratio (NSFR), the implementing regulations for which were proposed in the United States in 2016, would require affected banks to hold a complex formula of “stable funding” relative to their asset composition and business activities, based on a one-year time frame.

Overview

Over the past eight years, the banking industry has worked hard to make liquidity risk monitoring and mitigation significantly more robust—efforts intended to make both individual banks and the system as a whole more resilient. U.S. bank supervisors require that banks establish strong, internal reporting and governance frameworks to measure, monitor, and mitigate liquidity risk. Under these frameworks, covered banks’ (those defined as having more than \$50 billion in assets) must assess their funding needs, costs, and sources over various time horizons and scenarios—including both normal and stressed conditions. Additionally, as a precaution against any future liquidity stress event, banks are required to hold liquid assets and have in place comprehensive contingency funding plans, which establish an operational framework for handling a liquidity event, including designating emergency funding sources. These are sound principles, fully embraced by the banking industry.

The global standards, particularly the LCR and prospective NSFR, as embodied in U.S. regulation go beyond what is needed to for a strong and resilient liquidity program and in doing so suffer from serious problems that pose dangers to the U.S. financial system and to the financial institutions to which the rules are applied. They have an excessively complex structure that in significant ways does not fit with realities in the U.S. while imposing requirements that are prone to exacerbate liquidity problems in times of financial stress, and foment—rather than relieve—systemic instability. These regulatory problems need to be resolved expeditiously, and certainly well before the next bout of strains test the U.S. economy.

U.S. banks are relied upon, in good times but especially in times of trouble, as a readily accessible safe harbor for customer deposits, available for investment and withdrawal on demand by bank customers. During the recent recession and financial crisis, deposits at U.S. banks grew by more than a trillion dollars. The LCR, however, requires U.S. banks to operate as if the industry loses deposits during times of financial stress. The product of extended international negotiations, neither the LCR nor the NSFR properly considers the experience of U.S. banking organizations, the behavior of their customers, the depth and breadth of U.S. financial markets, or the current regulatory framework in the United States. The result works to discourage banks from some of the key functions which they are relied upon to perform, including deposit taking, and providing long-term credit.

While there are unquestionably some basic principles of liquidity that apply to banks universally, an institution’s liquidity position is inherently affected by local laws, traditions, financial

structure, and other conditions particular to one nation or jurisdiction. When implementing the LCR, and proposing the NSFR in the U.S., it was not clear if the banking agencies performed analysis outside of gathering data from a handful of internationally active banks as part of the Basel Committee's quantitative impact study.

We recommend a Treasury-led review of these liquidity standards to ensure that they suitably fit U.S. conditions and markets, including consideration as to whether the appropriate purposes of liquidity standards can be effectively met with less complexity. Particular attention might focus on how these rules as they exist may operate to exacerbate liquidity problems and foster financial instability, not the least of which would be how they might inhibit deposit taking or promote a pullback by financial institutions in the face of an economic downturn.

I. The LCR Promotes Hoarding of Liquid Assets, Constrains Bank Deposit Taking, and Works to Destabilize the Economy

The LCR (as embodied in U.S. regulation), which requires banks to hold High Quality Liquid Assets (HQLA) equal to regulatorily posited funding out flows in a period of stress, was promoted as an effort to standardize liquidity supervision according to global rules applied locally. Unfortunately, the rules go well beyond that, into internationally negotiated micromanagement of liquidity. The LCR's practicality is diminished by its complexity, granularity, and lack of compatibility with U.S. bank customers and markets.

a. Too narrow definition of HQLA

A central concern is the LCR's restrictive limitation on the types of assets that qualify as HQLA. The LCR qualifies as HQLA primarily cash and government instruments, with a limited and heavily discounted allowance for a few other debt securities such as those issued by government-sponsored enterprises, certain investment grade corporations, and a few states and municipalities. The LCR's thin definition not only fails to recognize the strength of U.S. financial markets and the actual quality of assets available for liquidity purposes, but it is also excessively pro-cyclical.

The narrow LCR definition of HQLA creates a comparably narrow operational supply, inadequate to meet demand in times of economic stress, reinforcing stress conditions. Indeed, availability is likely to be inverse to demand in times of trouble, when holders of HQLA will be incentivized to maximize holdings the more that they see demand increase and supplies wither. What was deemed by standard setters to be liquid will prove to offer only one-way liquidity: easy to sell but hard to buy.

These problems are worsened when we recognize that many market participants will covet these same HQLA-qualified assets as collateral for a variety of other regulatory requirements. For example, regulations regarding derivatives transactions and money market mutual funds (MMMFs) significantly increase the demand for Treasury securities. Collateral and margin rules in the swaps markets favor use of Treasuries and disfavor reliance on other financial instruments. Securities and Exchange Commission regulations require certain MMMFs to hold a minimum level of high quality assets as a buffer against liquidity risk. More broadly, the regulatory imposition of a floating net asset value (NAV) on prime funds is driving investors to shift

investments to MMMFs holding government securities, since these funds are exempt from floating NAV requirements. Those funds in turn are increasing the demand for Treasuries to accommodate their investors.² Economic turmoil can be expected to accentuate investor shift into MMMFs not subject to floating values.

Financial firms facing short supplies of HQLA will be forced by regulatory strictures to reduce lending, investment, and other financial activities beyond actual economic conditions in order to maintain the regulatory-mandated ratio of assets in line with their straitened supply of HQLA. Were shortages to become severe, conditions for panic could arise.³ The safety of the financial markets will become seriously tried by action of the LCR, economic problems exacerbated by problems in the regulations.

The problems of a narrow HQLA, increasingly recognized by market participants, can influence actions even during apparent market tranquility as they encourage aggressive acquisition of HQLA in good times. In addition to the systemic concerns, bank investment in debt securities other than Treasuries is relatively discouraged, decreasing liquidity in markets disfavored by the LCR. Those include markets for municipal securities, corporate debt, and secondary mortgages, among others.

Liquidity is not static, but the LCR definitions are. No asset classes have escaped liquidity issues; many assets are more liquid than the LCR allows. Is it wise to fix in regulation the assumption that government securities will always be highly liquid under all conditions? The insolvency problems of the Greek Government have reminded investors that sovereign instruments can become very risky. U.S. Treasury securities are subject to market losses when interest rates rise. Municipal and corporate debt instruments can provide much more reliable liquidity value than the LCR tolerates. In short, there is much more liquidity in the U.S. financial markets than the static measures of the LCR recognize. The current rule shortchanges the resilience of the U.S. economy, and the LCR's regulatory-induced scarcity of liquidity will prove to be destabilizing in times of economic trouble. Ideally, there should be a mechanism to recognize and harness the dynamism of U.S. markets and provide for a more dynamic identification of HQLA-qualified assets.

b. Incorrect assumption that deposits leave banks during times of stress

A bank's required amount of HQLA is determined by the degree to which complex standards predict funding will leave the bank in a period of idiosyncratic or systemic stress. It is important, then, that the LCR's assumed outflows and attendant run-off rates are reflective of actual U.S. experience. Instead the standards are governed by global averages and compromises developed in the Basel negotiations. One of the most glaring errors is the LCR's failure to recognize the role of U.S. banks as safe havens during times of stress.

² Recent negative interest rate policies by central banks in Europe and Asia have also constrained supply by stimulating demand—even by foreign governments—for holding U.S. Treasury instruments, which offer positive yields.

³ Panic occurs when people believe that they need to have something and they cannot get it. The LCR makes bank holdings of HQLA mandatory, against which loans and other financial assets become expendable. Yet what appears liquid today will likely become hoarded or illiquid in a recession or even the approach to recession.

The LCR, as implemented in U.S. regulations, mandates the assumption that banks will lose deposits in troubled economic conditions. While that may be the pattern in other parts of the world, the U.S. experience is just the opposite. During the recent recession, U.S. banks saw an influx of domestic deposits by \$813 billion from immediately before the start of the recession in December 2007 until its official end in June 2009, as savers looked to banks as a safe haven to place their money.

Not only is this run off assumption wrong in the U.S. experience, it will be harmful in future economic downturns. The counterfactual rigor of the LCR will constrain the ability of the banking industry in a future recession to accommodate the typical deposit inflow. The rules require banks to hold considerably higher amounts of HQLA against, for example, institutional deposits, which are treated punitively on the incorrect assumption that the deposits will flee. As deposits, instead, flood in at the sign of trouble, banks will need to seek substantially more HQLA, which will be difficult if not impossible to find. To the extent that HQLA is scarce—as can be expected by virtue of its too narrow definition—banks could be in a position of having to limit or even turn deposits away. LCR can force banks to abandon their traditional deposit safe harbor role, further eroding confidence in an economic downturn. Where will these depositors go? And what further strain will that place on economic activity?

While the LCR is aimed at larger institutions, it also impacts community banks by changing the markets in which all banks operate. For example, because the LCR favors retail deposits over other types of funding, competition for retail deposits is already increasing, making them more expensive for all banks.

We believe that these are consequences, though already materializing, that neither banks nor policymakers intended. These unintended consequences will be further exacerbated by the requirement that covered holding companies must publish their LCR and certain of its components, which in fact may likely increase the very types of confidence risks to systemic stability and to financial institutions that the LCR is designed to mitigate—that is, the risk of depositor and creditor runs.⁴

II. The NSFR Is Harmful when not Superfluous

The fundamental weaknesses of the LCR would be exacerbated by the layering on of another Basel liquidity standard, the NSFR, which uses and thereby reinforces the flawed LCR definitions. The NSFR, proposed in 2016 for U.S. implementation,⁵ is intended to promote longer-term sources of funding of bank activities.

An unfortunate effect of the NSFR would be to impair one of the basic functions of the American banking industry, maturity transformation. An essential role of banks is to serve as intermediaries between savers and borrowers. Savers want the option of ready access to their

⁴ Federal Reserve System, Liquidity Coverage Ratio: Public Disclosure Requirements; Extension of Compliance Period for Certain Companies to Meet the Liquidity Coverage Ratio Requirements (Dec. 19, 2016), available at https://www.federalreserve.gov/newsevents/press/bcreg/bcreg_20161219a1.pdf.

⁵ The implementing regulation was proposed on May 3, 2016; the public comment period closed on August 5, 2016. The proposal has not been finalized.

money, while borrowers prefer time to put borrowed money to work and to make repayment. Banks take in short-term funds (deposits) and lend long, and work to manage the difference. The underlying theory of the NSFR is that banks should reduce that difference and match as much as possible the maturities on the funds that they get from savers with the maturities of the loans that they make. Without these maturity transformation services, however, there would be a lot less ability to serve the needs of borrowers and therefore a lot less need for the funds of savers.

The longer maturities of loans reduce the costs to the families who use the funds to buy houses, cars, and finance educations, much of which would be unaffordable on short-term. Businesses borrow in terms of years to allow the acquisition of plant and equipment, the development of business activities and other projects, most of which take time to generate revenues. Banks manage the risks involved in the difference between those needs. That is what banks do.

Banks constantly monitor their supply of depositors and other sources of funds, just as they do the conditions of their borrowers. How well banks perform these duties is one of the central jobs of bank examination. The various regulatory stress tests put bank funding sources and assets through rigorously negative scenarios to see how they stand up. Regulators have developed and apply to the largest banks a Comprehensive Liquidity Assessment and Review (CLAR) that annually evaluates current and anticipated future liquidity conditions on a dynamic basis. And bank regulators have already imposed complex liquidity reporting requirements on institutions with over \$10 billion in assets.

Aside from these issues of harm, the NSFR is at best redundant. It offers nothing of prudential value that is not already covered by the ample body of regulatory standards and data collections implemented in the United States since 2009, when the Basel group first began its work on the liquidity standards. In the intervening years, many enhancements to liquidity regulation and supervisory liquidity monitoring have been adopted domestically, including—

- The LCR
- The Comprehensive Liquidity Assessment and Review (CLAR)
- The Method 2 GSIB surcharge calculation
- Complex institution liquidity reporting (Form FR 2052a)
- Liquidity stress testing and other requirements of Section 165 of the Dodd-Frank Act (including Resolution Plans)

Given this substantial regulatory framework already in place in the United States, it is unclear why the NSFR is necessary or why the supervisory process is insufficient to address any remaining firm-specific matters. In other words, it is hard to discern any value that the NSFR brings to bank supervision or bank management not already provided by other regulatory tools and practices.

Moreover, the details of the NSFR are in numerous instances out of date or otherwise structurally and fundamentally flawed. For example, the NSFR (as proposed by the U.S. banking agencies) confuses available liquidity in short-term stress with long-term funding needs and exacerbates the dangerous effects of the LCR's flawed definitions and assumptions. Furthermore, the ratio does not accurately measure liquidity risk. First, a bank's liquidity risk is largely reflective of the current environment, which dictates the cost of funding and the market liquidity of the bank's assets. The NSFR is based on a one-year horizon, and therefore too long-term to measure

accurately measure a bank's liquidity position. Second, a static ratio that only provides a snapshot in time does not accurately reflect a bank's more dynamic funding risks and resolutions, nor the significant potential to replace lost business over the longer term.

One of the key themes in the NSFR scheme, is that the duration of an asset should be more closely matched by the duration of its funding source. While in theory this makes sense, it misses, one of the important economic roles of banking: maturity transformation.

In short, the NSFR would plow ground that has already been seeded by more effective, appropriate, and dynamic measures of short- and long-term liquidity. It would be more than disruptive.

III. Specific Recommendations

It is imperative that liquidity supervision support safety and soundness and financial stability in conformance with U.S. laws, markets, banking practices, national financial culture, and counterparty behavior.

We recommend the following actions to strengthen the effectiveness of liquidity practices and supervision, and to avoid major regulatory problems. These are all steps that can be taken by regulatory authority, not requiring any changes in legislation.

- **Broaden HQLA eligible assets.** U.S. markets are deep and broad, with a plethora of high quality assets available. There is more liquidity than the rules recognize or allow. Increasing the types of assets permissible in the definition of HQLA will avoid the destabilizing shortages that can exacerbate trying financial conditions. It will also diversify bank holdings, and permit banks to create an HQLA portfolio that is more resilient to a variety of financial and economic challenges, mitigating liquidity risk.

An initial, immediate step would be to align the LCR's definition of HQLA to the types of assets that the Federal Reserve accepts as collateral for its lending programs. This would help solve for the destabilizing problem caused by the LCR's static definition of HQLA, because the Federal Reserve periodically reviews and adjusts collateral eligibility. The list of HQLA eligible assets under the LCR would thereby reflect current market conditions. Additionally, due to the broader scope of Federal Reserve eligible assets, aligning HQLA to the Federal Reserve, would lessen the pro-cyclicality of the current LCR. The Federal Reserve process of assessing various asset classes and identifying their eligibility is well established and familiar to financial markets.

- **Revisit the run-off rates and funding obligations assumed in the LCR.** The LCR touches almost every aspect of a bank's balance sheet and cash flows, hardwiring static assumptions about asset liquidity and the sources and uses of available funding. We recommend revisiting the assumptions assigned to various products, funding sources, and operational line items to ensure their appropriateness for both U.S. market conditions, business practices, and liquidity management.

For example, in the United States, the vast majority of state, local, and municipal deposits are required by state law to be collateralized. Instead of treating these as *deposits*, the LCR looks to the *collateral* and judges the instrument's liquidity value by that collateral as measured by the rule's own narrow and static definition of HQLA. Treating municipal deposits based on the nature of the collateral supporting them turns on its head the depositor relationship. It would be more appropriate to exclude collateralized deposits from the LCR or at the very least treat the deposits by taking into consideration the historical behavior of the *depositor*. Given the longstanding relationships banks typically have with their municipal depositors, in practicality the collateral is irrelevant to the "stickiness" of the deposits.

Similarly, the LCR treatment of operational deposits and non-financial corporate deposits does not comport with U.S. experience. The LCR should be revised to recognize that the banking industry gains rather than loses deposits in times of economic or financial stress. This change would facilitate, rather than inhibit, the ability of banks to continue their essential and market-calming role as financial havens.

- **Do not finalize the NSFR.** It is hard to discern any value that the NSFR brings to bank supervision or bank management not already provided by other regulatory tools and practices, and there is plenty of room for damage from its implementation. U.S. financial regulators should withdraw the NSFR proposal. At the same time they can announce that the U.S. financial system is in compliance with the spirit and purpose of this Basel proposal.