The Clearing House
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Statement for the Record
House Financial Services Committee
"Who's in Your Wallet: Examining How Washington Red Tape Impairs Economic Freedom"
April 8, 2014

Formed in 1853, The Clearing House Association L.L.C. ("The Clearing House") is the nation's oldest banking association. Today, The Clearing House advocates on regulatory, legislative, and legal public policy issues on behalf of the largest U.S. commercial banks before policy makers, courts of law, and standard setters in the United States and abroad. We welcome the opportunity to present our views on the current state of banking regulation and appreciate the Committee's attention to these issues.

As a result of recent regulatory reform and significantly improved bank capital, liquidity, and risk management practices, the banking system is stronger and safer than it was before the financial crisis. The Clearing House supports these reforms and improvements, including robust capital requirements focused on requiring banks to maintain higher quality capital, new liquidity standards, corporate governance reforms, an improved resolution framework, and recovery and resolution planning. We believe that as a result of these developments collectively, the banking system is more resilient than ever to withstand financial and economic shocks.

As many policymakers and others have observed, just as important as the shape of these regulatory reforms are the process and manner by which they are implemented into regulation. This is especially true of key components of Basel III and the Dodd-Frank Act—like heightened capital and liquidity standards—that touch fundamental aspects of banks' critical credit intermediation function, and as a result may have unintended and potentially negative consequences on the cost and availability of credit or other financial services to consumers and end users if not implemented appropriately. Accordingly, a key challenge in crafting and implementing new rules is to not only identify the prudential benefits of these rules, but also to identify and anticipate such negative consequences and to consider carefully the broader interaction among and between regulatory reforms in the aggregate. The Clearing House continues to urge policymakers to consider the cumulative impact of new regulations, rather than evaluating any one particular regulation in isolation, to ensure that the broader effect of proposed rulemaking on financial markets and the U.S. economy is identified and well-understood *before* these rules are finalized.

An illustrative and pertinent example of this concern is the U.S. banking agencies' recent notice of proposed rulemaking on the liquidity coverage ratio ("LCR"). The Clearing House has filed a comprehensive comment letter with those agencies describing our concerns about the potential unintended consequences that parts of that proposal could have on consumers, municipalities, and other bank customers, which we summarize below.

U.S. Liquidity Coverage Ratio

In October 2013, the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, and the Federal Deposit Insurance Corporation (collectively the "Agencies") issued a notice of proposed rulemaking entitled *Liquidity Coverage Ratio: Liquidity Risk Measurement, Standards, and Monitoring* (the "U.S. LCR Proposal").[1] That proposal would implement in the United States a portion of the international liquidity standards agreed to by the Basel Committee on Banking Supervision ("Basel LCR") by establishing an LCR for banking organizations that are mandatorily subject to the "advanced approaches" risk-based capital rules, their respective consolidated subsidiary depository institutions with total consolidated assets greater than $10 billion, and systemically-important nonbank financial companies designated by the Financial Stability Oversight Council that do not have substantial insurance activities.

The Clearing House believes that the final Basel LCR generally strikes an appropriate balance between accurately capturing liquidity risk and the concerns raised by banks during the public comment period with respect to, among others, the measurement of that risk and the scope of oversight and related compliance requirements. However, we are concerned that the U.S. LCR Proposal deviates significantly from the Basel LCR. These deviations detract from the goals of clarity and transparency across markets, competitive equality, and minimizing opportunities for regulatory arbitrage and the potential balkanization of national markets. We strongly believe that the LCR as implemented in the United States should deviate from the Basel LCR in significant ways when, and only when, unique circumstances impacting the liquidity risk of U.S. banks warrants such deviation. The effects of U.S. divergence from the Basel LCR may be exacerbated because of the interplay among the host of new regulations relating to capital, leverage, and other prudential standards.

In particular, two specific provisions of the U.S. LCR Proposal — the treatment of the secured deposits of U.S. municipalities and other public sectors entities ("PSEs") and the treatment of U.S. municipal securities — could have negative unintended consequences for U.S. municipalities and PSEs and their constituents.

1. <u>The treatment of secured deposits of U.S. municipalities and PSEs as secured funding transactions may impair the ability of banks to provide this critical service.</u>

Under the U.S. LCR Proposal, the required amount of high-quality liquid assets ("HQLA") is based on the assumed unwind of "any secured funding transaction, secured lending transaction, asset exchange, or collateralized derivative transaction that matures within 30-calendar days of the calculation date and where the [BANK] and the counterparty exchange HQLA."[2] The stated purpose of this mechanism is generally "to prevent a covered company from having a substantial amount of

[1] 78 Fed. Reg. 71,818 (Nov. 29, 2013).
[2] Proposed Rules, §§21(f)(1), (2) and (3).

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."[3] The core focus of this issue as set forth in the U.S. LCR Proposal appears to be "certain repurchase and reverse repurchase transactions"[4] — presumably due to the fairly ready ability to finance higher quality HQLA on the balance sheet through posting lower quality HQLA to a counterparty given the depth and scope of the U.S. repurchase/reverse repurchase market. While we acknowledge that there may be transactions and arrangements which could give rise to this issue, certain other arrangements which would seemingly be covered by a literal reading of the U.S. LCR Proposal do not in fact pose any material risk of a bank "manipulat[ing] its HQLA portfolio."[5]

In particular, we do not believe that deposits of U.S. municipalities — that under applicable state law[6] must be collateralized with liquid assets by the relevant depository institution — should be covered by the unwind mechanism because these deposits are fundamentally different in nature than typical secured funding transactions normally entered into by banks and pose very little risk of manipulation for purposes of the LCR and the pool of HQLA. As recognized in the Federal Deposit Insurance Act,[7] the laws of various states require that the deposits of certain municipalities and other PSEs must be "secured or collateralized" by the insured depository institution that holds such deposits. The amount of such deposits in the U.S. is significant, totaling approximately $443.6 billion as of September 2013.[8] These types of secured deposit arrangements are a critically important component of the suite of banking products provided by the banking industry to PSEs.

Secured municipal deposits are significantly different in nature than other types of secured funding transactions where banks, at their discretion, seek funding to finance their trading securities inventory from money market funds and other broker-dealers in the wholesale funding markets. From the perspective of a depository institution, secured municipal deposits are fundamentally first and foremost deposits where the customers, in this case various municipalities, seek to place their funds on deposit at the bank.

Moreover, these deposits tend to be stable, exhibiting relatively low volatility, and institutions use more stable portfolio collateral (as opposed to trading assets) to secure these types of balances. While literally "secured funding" for purposes of the U.S. LCR Proposal, municipal deposits are simply not the type of transactions susceptible to the risk of manipulation that the U.S. LCR Proposal and the Basel LCR apparently were focused on in this context as discussed above. In addition, empirical evidence indicates that, even during times of macroeconomic stress affecting the banking industry such as the 2008 financial crisis, secured deposits of PSEs generally experience only low withdrawal rates.

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[3] Preamble to the Proposed Rules at 71,832.
[4] *Id*. at 71,831.
[5] Preamble at 71,831.
[6] *See e.g.*, Ohio R.C. §§ 135.18, 135.181 and 135.37; 72 P.S. §§ 505 and 3836-1 *et seq.*
[7] *See* 18 U.S.C. 1831(m)(4).
[8] Based on data available from SNL Financial LC.

In addition, discouraging banks from providing secured deposit services to U.S. municipalities and other PSEs appears contrary to public policy goals. If secured deposits are indeed required to be unwound for purposes of the HQLA calculation, institutions subject to the U.S. LCR Proposal may have a strong incentive to stop offering these products to PSEs altogether because of the highly negative impact on their LCR calculations. Without ready and cost-effective access to banking services to manage their funds and operational deposits, many U.S. municipalities could have substantial practical difficulties in continuing to provide critical public services to their citizens, meeting their payroll for public servants, and more generally paying their day-to-day bills. We firmly believe this was not an intended consequence of the U.S. LCR Proposal.

If the Agencies nevertheless determine to subject secured municipal deposits to some form of unwind mechanism for purposes of the HQLA calculation under Section 21 of the U.S. LCR Proposal, we urge that the final U.S. LCR permit the use of the applicable LCR outflow assumption under Section 32 of the Proposal, subject to the proposed maximum of 15% and irrespective of the type of collateral being utilized, when performing the unwind calculation. We believe this treatment would be justified as a Country-Specific Circumstance because secured municipal deposits in the U.S. context are a fundamentally different type of secured funding due to the particular requirements of U.S. state law and an unwind of such deposits for purposes of the HQLA calculation would presumably only occur if and to the extent the deposit is withdrawn and a resulting outflow of cash and increase in HQLA, if any, occur. Additionally, bank call report data suggests that, even during the financial crisis for the quarters ending December 31, 2007 through September 30, 2009, peak secured municipal deposit run-off rates generally did not exceed approximately 15%.

2. <u>The deep, liquid markets for obligations of U.S. municipalities strongly support their inclusion as HQLA.</u>

Under the U.S. LCR Proposal, municipal securities, including debt securities issued by state or local governments, agencies, and authorities, do not qualify as HQLA as "the agencies believe, at this time, these assets are not liquid and readily-marketable in U.S. markets and thus do not exhibit the liquidity characteristics necessary to be included in HQLA under this proposed rule."[9] With nearly $3.7 trillion of securities and loans outstanding,[10] municipal securities play a critical role in the financing of our capital investment in public services and infrastructure and are an important part of the U.S.'s capital markets. We believe that municipal securities should be treated as Level 2A liquid assets. Municipal securities meet the requirements for HQLA outlined in the U.S. LCR Proposal and in some respects are safer and more liquid than assets recognized as HQLA.

The Preamble to the U.S. LCR Proposal describes the characteristics of assets that qualify for inclusion as HQLA, such as assets that are "easily and readily valued" and "lower risk", "do not incur sharp price declines", benefit from "active outright and repurchase markets at all times with significant diversity in market participants as well as high volume", and may be "pledge[d] at a central bank as

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[9] Preamble at 71,827.

[10] Board of Governors of the Federal Reserve System, Flow of Funds, Balance Sheets, and Integrated Macroeconomic Accounts, Third Quarter 2013, Table L.211, page 98.

collateral for intraday liquidity needs and overnight liquidity facilities."[11] Municipal securities exhibit all of these qualities. The municipal market is liquid with a diverse mix of participants, including retail and institutional investors as well as over 1,650 registered dealers,[12] and price quotes are readily available from dealers on almost any transaction. The municipal trading market is also robust, with a higher daily turnover rate in 2012 than the turnover rate for corporate bonds.[13] Furthermore, based on historical performance, municipal securities are arguably more price-stable and do not experience any greater loss of liquidity during periods of stress than other securities which are considered HQLA under the U.S. LCR Proposal. For example, the cumulative ten-year default rate for BBB-rated municipal securities is 0.3% while BBB-rate corporate bonds exhibit a 4.74% cumulative ten-year default rate.[14] Finally, banks subject to the proposal may use municipal bonds as collateral for discount window advances as well as to offset risks associated with extensions of daylight credit of master account activity.[15]

In addition, the U.S. LCR Proposal's treatment of municipal securities is inconsistent with the treatment recommended by the Basel Committee. Under the Basel LCR, "marketable securities representing claims on or guaranteed by sovereigns, central banks, PSEs or multilateral development banks" are treated as Level 2A liquid assets where PSEs include governmental entities other than a central government including U.S. state and local governments.[16] U.S. municipal securities meet the criteria outlined in the Basel LCR and any departure from the Basel LCR is not warranted by Country-Specific Circumstances. Therefore, the Agencies should align their treatment of municipal securities with the Basel LCR and assign municipal securities to Level 2A.

Interaction between the U.S. LCR Proposal and Other Rulemakings

A key challenge for the Agencies and other regulators, including securities and commodities regulators in the United States as well as banking and other functional regulators in other countries, has been to anticipate and accommodate the interaction among and between macroprudential initiatives. In this respect, it is important to fully evaluate the extent to which the U.S. LCR Proposal could interact with various other rules in ways that are unproductive and likely unintended. For example, while the U.S. LCR Proposal would require covered banks to hold large amounts of HQLA in specified types, a pending U.S. leverage ratio proposal would effectively penalize such holdings by requiring capital for such holdings well in excess of their actual risk.[17] This dynamic would both (i) cut directly against the

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[11] Preamble at 71,827.
[12] Municipal Securities Rulemaking Board, "MSRB Registrants," www.msrb.org/msrb1/pqweb/registrants.asp.
[13] Based on the average daily trading volume in relation to total volume outstanding, in 2012 0.35% of total outstanding municipal securities traded each day versus 0.24% of outstanding corporate bonds. *See* Board of Governors of the Federal Reserve System, Flow of Funds, Balance Sheets, and Integrated Macroeconomic Accounts, Third Quarter 2013 Table L.212, page 99 (based on $11.1 trillion of corporate bonds outstanding on December 31, 2012 from data on "Nonfinancial corporate business" and "Financial sectors" including sub-investment grade).
[14] BNY Mellon Wealth Management, "Muni Bond Defaults, Bankruptcies and Bondholder Protections," August 2013, page 1.
[15] Federal Reserve System, "Federal Reserve Collateral Guidelines," January 2, 2013, page 3.
[16] Basel III: The Liquidity Coverage Ratio and liquidity risk monitoring tools, ¶ 52 (January 2013).
[17] Regulatory Capital, Enhanced Supplementary Leverage Ratio Standards for Certain Bank Holding Companies and Their Subsidiary Insured Depository Institutions, 78 Fed. Reg. 51,101 (Aug. 20, 2013).

global policy consensus around limiting liquidity risk as a threat to banks and markets, which is at least as important as addressing the risk of insufficient leverage capital and (ii) inevitably increase risks for banks and the financial system in times of stress by incentivizing banks to respond to that penalty by holding a lesser amount of HQLA than they otherwise would.

Similarly, the U.S. LCR Proposal interacts with recently-issued final rules by the Commodity Futures Trading Commission ("CFTC") relating to liquidity requirements for derivatives clearing organizations ("DCOs"). The CFTC rules require systemically-important DCOs, which are central counterparties ("CCPs") that have registered with the CFTC, to establish and maintain specified liquidity resources. The CFTC rulemaking, while only applicable to a subset of DCOs, is intended to implement the international Principles for Financial Market Infrastructures ("PFMIs") and is illustrative of the PFMI requirements that will be applicable to CCPs more broadly. We believe that the U.S. LCR Proposal does not anticipate CCP liquidity arrangements, which are generally designed as "back-up" liquidity resources to be used only when CCPs' balance sheet cash, initial margin and default fund cash resources are insufficient to meet CCPs' short-term liquidity requirements. As a result, we are concerned that a "100% outflow" treatment might apply to these arrangements, which is far in excess of historical drawdown rates. Such high drawdown rates, if applied, may materially increase the costs of clearing, impeding efforts to move more uncleared transactions to CCPs.

In addition, the U.S. LCR Proposal also interacts with proposed rules issued by the Securities and Exchange Commission ("SEC") in 2012 to establish regulatory liquidity standards for alternative net capital broker-dealers ("ANC B-Ds") and security-based swap dealers ("SBSDs").[18] Although all ANC B-Ds are controlled by banks subject to the U.S. LCR Proposal,[19] neither the SEC proposal nor the U.S. LCR Proposal addresses the interaction of these two proposed liquidity regimes. If the U.S. LCR Proposal and the SEC Liquidity Proposal are each finalized as proposed, banks controlling ANC B-Ds or SBSDs will be subject to uncoordinated, inconsistent requirements that could weaken centralized liquidity management. We recommend that the Agencies and the SEC should coordinate their rulemakings to establish a workable regime that promotes centralized liquidity management.

Conclusion

Although the U.S. LCR Proposal is only one example, it is apparent that implementation of post-crisis regulatory reform requires careful attention to both (i) the potential unintended consequences of proposed rules for businesses and consumers and (ii) the cumulative interaction and effect of these proposed rules. The Clearing House is committed to continuing to play a constructive role in the financial regulatory reform process by engaging with policymakers on how best to implement important policy measures in a thoughtful, complementary manner.

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[18] 78 Fed. Reg. 71,818, 71,852-54 (Nov. 29, 2013). See 17 C.F.R. §§ 15c3-1(f), 18a-1(f) (proposed).

[19] There are currently six ANC B-Ds, most of which are controlled by U.S. banking organizations. A foreign banking organization that controls an ANC B-D would likely be required to establish an intermediate U.S. holding company to control the ANC B-D under the Board's proposed foreign banking organization rulemaking. See 77 Fed. Reg. 76628 (Dec. 28, 2012).