June 21, 2019

Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551
Attention: Ann E. Misback, Secretary
Docket No. R-1658; RIN 7100-AF45; and
Docket No. R-1628; RIN 7100-AF21

Office of the Comptroller of the Currency
400 7th Street, SW, Suite 3E-218
Washington, DC 20219
Attention: Legislative and Regulatory Activities Division
Docket ID OCC-2018-0037; RIN 1557-AE56

Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429
Attention: Robert E. Feldman, Executive Secretary
RIN 3064-AE96

Re: SIFMA Comment on Liquidity Standards for Large Banking Organizations

Dear Sirs and Madams:

The Securities Industry and Financial Markets Association ("SIFMA")[1] appreciates the opportunity to comment on the following proposals by the federal banking agencies (the "Agencies") related to liquidity standards for large banking organizations:

- the proposed rule of the Board of Governors of the Federal Reserve System (the "Board") to revise the enhanced prudential standards rule (the "EPS Rule") (the "Board Proposal");[2] and
- the Agencies' proposed rule to revise interagency liquidity and capital requirements (the "Interagency Proposal," and together with the Board Proposal, the "Proposals").[3]

[1] SIFMA is the leading trade association for broker-dealers, investment banks and asset managers operating in the U.S. and global capital markets. On behalf of our industry's nearly 1 million employees, we advocate on legislation, regulation and business policy, affecting retail and institutional investors, equity and fixed income markets and related products and services. We serve as an industry coordinating body to promote fair and orderly markets, informed regulatory compliance, and efficient market operations and resiliency. We also provide a forum for industry policy and professional development. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA).

[2] 84 Fed. Reg. 21,988 (May 15, 2019).

[3] 84 Fed. Reg. 24,296 (May 24, 2019).

SIFMA has separately submitted comments to the Agencies related to the impact of the Proposals on foreign banking organizations ("FBOs"). The purpose of this comment letter is to respond to questions in the Board Proposal related to potential changes in liquidity standards for large banking organizations and to highlight related liquidity management issues raised by the Proposals, including with respect to the U.S. Liquidity Coverage Ratio ("U.S. LCR").

Our comments in this letter are organized into three sections:

- Section 1 responds to questions raised in the Board Proposal and supports greater alignment between High Quality Liquid Asset ("HQLA") standards in the U.S. LCR and Highly Liquid Asset ("HLA") standards in the EPS Rule;
- Section 2 responds to a statement in the preamble of the Interagency Proposal suggesting that the Agencies expect HQLA to be "continually available," and explains why, if the Agencies consider applying an intraday utilization requirement to HQLA, the Administrative Procedure Act ("APA") requires them to do so through a notice-and-comment rulemaking; and
- Section 3 provides constructive recommendations, based on nearly five years of operating experience with the U.S. LCR, for ways to strengthen and tailor the U.S. LCR to better promote liquidity resiliency, and make related changes to the U.S. Net Stable Funding Ratio ("U.S. NSFR").

I. Board Proposal: Potential Changes to Large Banking Organizations' Liquidity Standards under Regulation YY

Our responses to specific questions raised in the Board Proposal are provided below.

Question 36: How, if at all, should the Board adjust the current definition of highly liquid assets in 12 CFR 252.35(b)(3) and 252.157(c)(7) of the enhanced prudential standards rule to improve alignment with the definition of HQLA? Should the enumerated list of highly liquid assets be expanded to include any or all of certain categories of HQLA (e.g., level 1 liquid assets, all level 1 and level 2A liquid assets, certain level 1 liquid assets, certain level 2A liquid assets, etc.) or certain assets that are HQLA (e.g., sovereign bonds that are assigned a zero percent risk weight under the Board's capital regulation)? Should "cash" in the enhanced prudential standards rule be clarified to mean Reserve Bank balances and foreign withdrawable reserves, to more closely align with the enumerated list of level 1 liquid assets that are not securities in the LCR rule?

We support greater alignment between HQLA standards in the U.S. LCR and HLA standards in the EPS Rule. In particular, the Board should create greater alignment between the definitions of HLA and HQLA by classifying all HQLA as HLA. At present, there are only minor differences in practice between HQLA and HLA standards, owing primarily to the different purposes of the U.S. LCR and EPS Rule liquidity requirements, which we discuss below. Greater alignment would improve the coherence and efficiency of liquidity regulation of large banking organizations, and reduce the operational burden of the U.S. LCR and

EPS Rule imposing two overlapping liquidity buffers. Additionally, treating HQLA as HLA would be consistent with the Board's intent when it adopted the EPS Rule.[4]

Recognition of HQLA as HLA should not be limited to particular subcategories of HQLA (*e.g.*, Level 1). HQLA standards are rigorous, and non-Level 1 securities that meet HQLA requirements have demonstrable liquidity value and should be included as HLA. Moreover, since the EPS Rule requires firms to apply market and credit risk haircuts to securities, HLA standards provide a mechanism for ensuring risk-sensitive liquidity values for Level 2A and 2B HQLA when they are included as HLA.

While all HQLA should qualify as HLA, it would not be appropriate to limit HLA to HQLA. The U.S. LCR is a standardized liquidity framework; all firms subject to the U.S. LCR are required to apply effectively identical approaches when identifying HQLA and measuring U.S. LCR inflows and outflows. The Agencies calibrated the U.S. LCR to reflect a homogeneous funding shock based on experience in the financial crisis.[5] In contrast, the EPS Rule requires firms to hold HLA to meet net liquidity outflows as measured in Internal Liquidity Stress Tests ("ILSTs"), which firms necessarily and appropriately customize to test their institution-specific vulnerabilities and business models using factually-supported estimations for haircuts and inflow and outflow rates. The EPS Rule should continue, as it does today, to accommodate particular cases in which a firm determines that specific non-HQLA securities meet HLA standards. This flexibility would be consistent with the tailoring design of the EPS Rule's liquidity stress testing requirements. Illustrative regulatory text to implement these recommendations in the EPS Rule is included in <u>Annex A</u> to this letter.

We do not believe there is any compelling reason to exclude cash on deposit at an agent bank from HLA. However, if the Board nevertheless limits the recognition of cash to Reserve Bank balances and foreign withdrawable reserves, it should also reclassify non-central bank overnight cash reserves from HLA to Day 1 cash inflows for purposes of ILSTs. Reclassifying non-central bank cash reserves in this manner would avoid impacting overall ILST-based liquidity requirements, since stress period net liquidity outflows would be reduced by the amount of non-central bank cash that formerly qualified as HLA.

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[4] *See* 79 Fed. Reg. 17,259 (Mar. 27, 2014) (preamble to final EPS Rule stating that "[a]ssets that are high-quality liquid assets under the proposed U.S. LCR (which include equities included in the S&P 500 index or comparable indices and investment grade corporate bonds) would be liquid under most scenarios").

[5] *See* 79 Fed. Reg. 61,439, 61,444 (Oct. 10, 2014) (preamble to final U.S. LCR rule stating that "the measure of net cash outflow and the outflow and inflow rates used in its determination are meant to reflect aspects of historical stress events including the recent financial crisis.").

Question 37: What are the advantages and disadvantages of incorporating into the definition of highly liquid assets other requirements of the LCR rule related to HQLA, including, for example, the requirements for an asset to be "eligible HQLA," the haircuts applied to HQLA, or the quantitative limits on the composition of the HQLA amount?

While the Board should align the definitions of HLA and HQLA so that all HQLA qualify as HLA, we do not believe that it would be consistent with the design or spirit of the EPS Rule to require mandatory application of U.S. LCR haircuts or quantitative limits when determining HLA values.

An important purpose of the EPS Rule is to require firms to develop comprehensive risk management practices and develop clear rationales and justifications for their ILSTs. The EPS Rule thus requires firms to design ILSTs that are tailored to their institution-specific vulnerabilities and business models. Requiring firms to develop their own haircuts and quantitative limits is consistent with the EPS Rule's approach of promoting independent liquidity risk management. Applying a set of standardized haircuts or quantitative limits, on the other hand, would be inconsistent with this approach and decrease the usefulness of the EPS Rule as a tool for promoting active risk management. Standardized haircuts necessarily become incorporated into industrywide risk management practices. For example, if the Board were to adopt standardized haircuts that were calibrated incorrectly, the error would be replicated across all large banking organizations, creating systemic risk.

In addition, we are unaware of any empirical evidence suggesting that U.S. LCR haircuts and quantitative limits are appropriately designed for the EPS Rule. U.S. LCR haircuts and quantitative limits are grounded in the Basel Committee on Banking Supervision's LCR framework (the "BCBS LCR"), and reflect standardized assumptions that are intended to be suitable across a wide array of business models and markets. These standardized assumptions have no applicability in the EPS Rule, which emphasizes firm-specific ILSTs and independent judgment.

Further, while we recommend that all HQLA should qualify as HLA, there may be circumstances in which non-HQLA could qualify as HLA. In these cases, there would be no applicable U.S. LCR haircut or quantitative limit, which would create inconsistency and incoherence in the EPS Rule.

Therefore, the EPS Rule should continue to require firms to evaluate all securities' market and credit risk characteristics, and apply market and credit risk haircuts, in a manner similar to the current development of ILSTs. In this way, the EPS Rule would promote strong and independent risk management practices as a check on the U.S. LCR and serve as a safety valve in the event the U.S. LCR's standardized haircuts were calibrated incorrectly.

The Board has also solicited comment on whether, for purposes of the EPS Rule, HLA should meet requirements for an asset to be eligible HQLA (including all of the LCR's operational requirements). As noted in our response to the previous question, we believe that all HQLA should qualify as HLA to promote greater coherence and alignment across related regulatory frameworks. However, firms should continue to have the opportunity to determine that assets qualify as HLA even if they do not meet the operational or other requirements to be treated as eligible HQLA. Given the focus of the EPS Rule on

individualized risk management standards and processes, the Board should continue to allow and require firms to apply independent judgment in assessing operational and other risks in the context of HLA. To do otherwise would make the EPS Rule's liquidity buffer requirement and the U.S. LCR duplicative of each other, calling into question why both requirements are necessary.

Question 38: If a firm's HQLA satisfy the requirements in the LCR rule to be eligible HQLA, what are the advantages and disadvantages of requiring the firm to separately demonstrate that the HQLA meet the other requirements in the enhanced prudential standards rule for highly liquid assets? What would be the advantages and disadvantages of adding other requirements for highly liquid assets in the enhanced prudential standards rule, including a requirement that a firm take into account potential conflicts to a business or risk management strategy stemming from the monetization of these assets?

Please see our answer to question 37, above, for an explanation of why the Board should not modify the EPS Rule to import the U.S. LCR's operational requirements for an asset to be treated as eligible HQLA.

If question 38 is intended to solicit comment on whether the Agencies should amend the U.S. LCR to require that eligible HQLA meet HLA requirements, we believe that such amendments would be inappropriate, for four reasons. First, U.S. LCR HQLA should generally align with corresponding standards in the BCBS LCR to promote consistency and harmonization of key prudential regulations across major markets. Layering HLA requirements into the U.S. LCR would add unnecessary complexity to the regulatory framework and undermine global harmonization efforts.

Second, while HLA standards are generally similar to HQLA standards, there are key differences that would prevent wholesale importation of HLA standards into the U.S. LCR. Most importantly, the EPS Rule requires firms to discount the fair market value of assets to reflect any credit risk and market price volatility of HLA. The U.S. LCR already includes standardized haircuts for HQLA, so requiring a second set of EPS Rule-prescribed haircuts in the U.S. LCR would be duplicative and introduce unnecessary complexity.

Third, adding HLA requirements, which are firm-specific, to the U.S. LCR would undermine the utility of the U.S. LCR as a standardized measurement tool for the public to use in comparing and contrasting firms.

Fourth, there is no apparent reason to amend the U.S. LCR to layer into additional HLA requirements. The Board has not cited any shortcoming of the U.S. LCR that would warrant such an amendment, and we note that the question is raised only by the Board Proposal, posing a procedural hurdle if the other Agencies sought to follow a similar approach.

II. Interagency Proposal: Potential Application of an Intraday Utilization Requirement in U.S. LCR Eligible HQLA Standards

The preamble to the Interagency Proposal describes a regulatory expectation that HQLA held by an FBO's U.S. operations be "continually available."[6] This expectation of continual availability does not appear in the U.S. LCR rule's text or the preamble to the 2014 final U.S. LCR rule, and may suggest that the Agencies are considering whether to apply an intraday utilization requirement in U.S. LCR eligible HQLA standards, as the UK Prudential Regulatory Authority did earlier this year before declining to adopt such a requirement at this time.[7]

The U.S. LCR, as adopted through a final rulemaking in 2014, does not include an intraday utilization requirement for eligible HQLA. Section 10(a) of the U.S. LCR clearly states that LCR calculations, including the LCR numerator, must be calculated "at the same time" each day, meaning that the LCR is a point-in-time calculation that was not designed to reflect intraday liquidity risks. If the Agencies had intended to impose an intraday utilization requirement, they had existing language they could have used to refer to intraday liquidity more clearly; the EPS Rule imposes an intraday liquidity monitoring requirement and preceded the adoption of the U.S. LCR.

Indeed, the regulatory history of the U.S. LCR confirms that the Agencies did not establish or intend to establish an intraday utilization requirement:

- The Agencies' 2013 U.S. LCR proposed rulemaking solicited comments on whether there should be "any limits with regard to covered companies' ability to transfer HQLA on an intraday basis between entities" and asked what "appropriate limits should the agencies consider with regard to intraday movements of HQLA between domestic and foreign entities, including foreign branches."[8] The Agencies did not, however, solicit comments on intraday utilization of HQLA outside of affiliate transactions.

- While section 22(a)(2)(ii) of the U.S. LCR refers, in connection with HQLA operational requirements, to firms "implementing and maintaining appropriate procedures and systems to monetize any HQLA at any time in accordance with relevant standard settlement periods and

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6 84 Fed. Reg. at 24,318.

7 *See* Prudential Regulation Authority, Policy Statement PS13/19; Pillar 2 liquidity: Updates to the framework (June 2019), *available at* https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/policy-statement/2019/ps1319.pdf?la=en&hash=4B5881641AE55FED077B197751C709DCDD062067. The PRA originally proposed to redefine UK LCR encumbrance standards to disqualify from the HQLA amount, in certain circumstances, securities that are pledged to generate intraday liquidity, even if these securities are otherwise unencumbered at the close of each business day when UK LCR calculations are performed. *See* Prudential Regulation Authority, Consultation Paper CP6/19; Pillar 2 liquidity: Updates to the framework, p. 21 (Mar. 2019), *available at* https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/consultation-paper/2019/cp619.pdf?la=en&hash=0335768FFE5B1A10136A4D85E8B5C2111A02912A. The PRA consultation proposed to disqualify securities from inclusion in the UK LCR numerator, which is equivalent to disqualifying securities from the HQLA amount in the U.S. LCR.

8 78 Fed. Reg. 71,818, 71,823 (Nov. 29, 2013).

procedures" and "demonstrating the ability to monetize the assets and making the proceeds available to the liquidity management function without conflicting with a business or risk management strategy of the [bank]," the preamble to the 2013 proposed rule explained these requirements as designed to prevent market risk hedge securities from being recognized as eligible HQLA rather than as an intraday utilization requirement.[9]

- The preamble to the 2014 final rule did not discuss HQLA intraday utilization at all and its description of HQLA operational requirements followed that of the 2013 proposed rulemaking, focusing on disqualifying market risk hedges.[10]

- Discussion of an intraday utilization requirement is also absent from any official guidance following the publication of the 2014 final rule, including the FAQs the Agencies published in 2017.

If the Agencies intend to impose an intraday utilization requirement in U.S. LCR Eligible HQLA standards, the APA requires them to first issue a notice of proposed rulemaking to amend the U.S. LCR. Under the APA, a federal agency seeking to promulgate or amend a "rule" that is not an "interpretative rule" is required to go through notice-and-comment procedures.[11] Given that the current U.S. LCR plainly does not include an intraday utilization requirement, the adoption of such a requirement would be a "rule"[12] that is not an "interpretative rule."[13] And the Agencies' statement in the preamble of the Interagency Proposal is not sufficient to satisfy the requirements of the APA.[14]

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[9] 78 Fed. Reg. at 71,829 ("[A] covered company would be required to implement policies that require all HQLA to be under the control of the management function of the covered company that is charged with managing liquidity risk. To do so, a covered company would be required either to segregate the assets from other assets, with the sole intent to use them as a source of liquidity or to demonstrate its ability to monetize the assets and have the resulting funds available to the risk management function, without conflicting with another business or risk management strategy. Thus, if an HQLA were being used to hedge a specific transaction, such as holding an asset to hedge a call option that the covered company had written, it could not be included in the HQLA amount because its sale would conflict with another business or risk management strategy. However, if HQLA were being used as a general macro hedge, such as interest rate risk of the covered company's portfolio, it could still be included in the HQLA amount. This requirement is intended to ensure that a central function of a covered company has the authority and capability to liquidate HQLA to meet its obligations in times of stress without exposing the covered company to risks associated with specific transactions and structures that had been hedged. There were instances at specific firms during the recent financial crisis where unencumbered assets of the firms were not available to meet liquidity demands because the firms' treasuries were restricted or did not have access to such assets.").

[10] 79 Fed. Reg. at 61,467.

[11] 5 U.S.C. § 553(b). *See also* 5 U.S.C. § 551(5) (defining "rule making" as "agency process for formulating, amending, or repealing a rule").

[12] "Rules" subject to the APA notice-and-comment requirements include any "agency statement of general or particular applicability and future effect designed to implement, interpret, or prescribe law or policy." 5 U.S.C. § 551(4). A statement has "general applicability" if it "has a substantial impact on [a] regulated industry," or on a class of that industry. Phillips Petroleum Co. v. Johnson, 22 F.3d 616, 620 (5th Cir. 1994) (quotation omitted); Natural Res. Def. Council v. EPA, 966 F.2d 1292, 1309 (9th Cir. 1992). A statement has "future effect" if it has prospective effect. *E.g.*, Citizens to Save Spencer County v. EPA, 600 F.2d 844, 879–80 (D.C. Cir. 1979).

[13] An "interpretative rule" "merely clarif[ies] or explain[s] existing law or regulations. Alcaraz v. Block, 746 F.2d 593, 613 (D.C. Cir. 1984). In contrast, a "legislative rule," which is subject to notice-and-comment procedures, "is
(continued…)

Any effort to incorporate an intraday utilization requirement in the U.S. LCR raises a variety of technical and definitional points that would be appropriately resolved through a public rulemaking process. More broadly, expanding the U.S. LCR to include intraday utilization standards would raise meaningful questions around the scope and measurement of intraday liquidity usage, which suggests that public notice and a meaningful opportunity to comment would be necessary to ensure consistent and uniform practices across all regulated firms if the Agencies wanted to explore this issue further.[15]

III. Broader Comments on the Design and Operation of the U.S. LCR after Five Years of Operational Experience

SIFMA strongly supports the policy objectives of the U.S. LCR and, in general, believes that the U.S. LCR is well-designed to achieve those policy objectives. As with any significant regulatory framework, however, the U.S. LCR should be subject to periodic reevaluation by the Agencies to determine which elements of the framework work well and which elements require refinement. As we approach the fifth anniversary of the adoption of the U.S. LCR, it is now an appropriate time to highlight particular areas where the U.S. LCR could be strengthened and/or tailored.

Based on our members' experience complying with the U.S. LCR, we also offer suggestions to calibrate certain related aspects of the Agencies' proposed U.S. NSFR to better reflect actual funding risk and harmonize the U.S. NSFR with global standards. We maintain, however, that a more fundamental reevaluation of the U.S. NSFR proposal is warranted to address its serious conceptual and design flaws, such as its arbitrary treatment of derivatives transactions and punitive treatment of securities financing transactions, which SIFMA discussed in its comment letter on the 2016 U.S. NSFR proposal.[16]

A. Liquidity-related public disclosures

The Board has required large banking organizations to publicly disclose their U.S. LCRs and subcomponents since 2017. The Board's rules generally require that firms make these disclosures within 45 calendar days of a quarter-end, with a slightly longer period permitted for year-end disclosures to align with Form 10-K filing timelines required by the SEC.[17]

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recognizable by virtue of its binding effect." State of Alaska v. U.S. Dep't of Transp., 868 F.2d 441, 445 (D.C. Cir. 1989).

[14] Any "rule" subject to the notice-and-comment procedures of the APA must include "either the terms or substance of the proposed rule or a description of the subjects and issues involved." 5 U.S.C. § 553(b)(3). The Agencies' statement in the preamble does none of these things.

[15] *See* Randal K. Quarles, Board, Vice Chairman for Supervision, "Early Observations on Improving the Effectiveness of Post-Crisis Regulation," p. 3 (Jan. 19, 2018), *available at* https://www.federalreserve.gov/newsevents/speech/files/quarles20180119a.pdf; Jelena McWilliams, FDIC, Chair, "Principles of Supervision and Your Value to our Nation's Banking System" (Mar. 21, 2019), *available at* https://www.fdic.gov/news/news/speeches/spmar2119.html.

[16] *See* SIFMA Comment Letter on U.S. NSFR Proposal (Aug. 5, 2016), *available at* https://www.sifma.org/resources/submissions/sifma-and-other-associations-submit-comments-to-multiple-agencies-on-net-stable-funding-ratio/.

[17] 12 C.F.R. §§ 249.90, 249.91.

As the industry has previously highlighted,[18] regulators in similar contexts have recognized the potential market disruption of disclosing sensitive liquidity information without a meaningful delay, because the public dissemination of such information poses broader pro-cyclical risk in the event of market-wide stress. The most pertinent example is a firm's borrowing from the Federal Reserve's discount window, which is only disclosed to the public after a period of approximately two years.

Board economists explained the reasoning for this two year lag in a 2017 research note on the discount window:

> During stress events, stigma may become even worse than in normal times. When investors are particularly concerned about difficulties at banks, they may pay extra attention to any signals of potential weakness. Investors in bank debt, including depositors, may also react more strongly to such signals in times of stress, particularly if they are not covered by deposit insurance. Thus, to the extent that a discount window loan is perceived as a negative signal, banks may be concerned that this signal could be taken more seriously by counterparties during periods of stress and may make extra efforts to avoid the discount window. This may impair the functioning of short-term funding markets, exacerbating the problems, and may lead to tighter financial conditions. Such a situation occurred following the 1987 stock market crash, where banks sought to hold larger amounts of reserve balances than before but were even more reluctant to borrow from the discount window. These concerns were even more prominent during the 2007-2009 financial crisis . . . .[19]

We continue to believe that there is no clear policy basis for the Board to provide discount window disclosures on a two-year lag while at the same time requiring large banking organizations to make U.S. LCR disclosures on a 45- or 60-day lag. The same policy rationale that justifies a two-year lag in discount window disclosures – a concern with self-reinforcing, pro-cyclical stigma effects when banking organizations face temporary liquidity constraints – applies equally, if not more forcefully, in the U.S. LCR context, since the U.S. LCR provides an overarching, consolidated view of a banking organization's liquidity profile. U.S. LCR disclosures should therefore be required on a two year lag.

The Agencies should also make three changes to the NSFR disclosure requirements as set forth in the 2016 U.S. NSFR proposal. First, as with the U.S. LCR, NSFR disclosures should be required on a two

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[18] *See* The Clearing House Association L.L.C. Comment Letter to the Board, p. 3 (Jun. 2, 2017), *available at* https://bpi.com/recent-activity/tch-files-comment-letter-on-lcr-disclosure-requirement/.

[19] Mark Carlson and Jonathan D. Rose, "FED Notes: Stigma and the discount window" (Dec. 19, 2017), *available at* https://www.federalreserve.gov/econres/notes/feds-notes/stigma-and-the-discount-window-20171219.htm.

year lag. The same policy rationale that justifies a two-year lag in discount window disclosures applies equally to the U.S. NSFR.

Second, NSFR disclosures should not be required until the U.S. NSFR has been effective for some time. Under the 2016 U.S. NSFR proposal, NSFR disclosure requirements would apply as soon as the final rule is effective. But any time after a new rule is introduced, firms spend time monitoring, managing, and engaging with regulators on interpretation questions and issues. Any new metric should have appropriate "seasoning" prior to public disclosure to allow for the resolution of these questions and issues. For example, the U.S. LCR rule was live for nine quarters before public disclosure was required.

Third, NSFR disclosures should be made on an average basis rather than a spot basis. Under the U.S. NSFR proposal, firms would be required to disclose their U.S. NSFRs on a spot basis at quarter-end along similar time lags as U.S. LCR disclosures. Disclosure of a firm's average U.S. NSFR over the quarter would give market participants and regulators a more appropriate view of the firm's funding position over time, as spot metrics may vary across business dates.

B. Liquid and readily marketable (LRM) test

The U.S. LCR includes granular standards that must be satisfied for a firm to determine that a particular asset is "liquid and readily-marketable." We support, in principle, the so-called LRM test, which helps to confirm that HQLA are traded in liquid markets that can be expected to remain liquid during stress periods, but believe that three technical refinements would improve the application of the LRM test.

First, in its current operation, the LRM test incorrectly disqualifies, simply because of data limitations, securities that are objectively liquid and readily marketable. The availability of data to satisfy U.S. LCR-defined LRM test requirements for a large number of asset classes is incomplete. This problem is compounded when the test is applied at a CUSIP level, for which the available data is even less complete. The Agencies could correct this problem by amending the LRM test to apply at an asset class level.

Second, because different asset classes have different liquidity characteristics (*e.g.*, buy and hold), the U.S. LCR should not impose a prescriptive list of LRM requirements; rather, the LRM test should be a more holistic analysis of the relevant characteristics of a particular asset class.

Illustrative regulatory text to achieve these outcomes is provided below:

> Liquid and readily-marketable means, with respect to a security's asset class, that the asset class ~~security~~ has a set of characteristics that evidence it is traded in an active secondary market ~~with~~, which may include, for example:
>
> > (1) More than two committed market makers;
> >
> > (2) A large number of non-market maker participants on both the buying and selling sides of transactions;

(3) Timely and observable market prices; and

(4) A high trading volume.

Third, the Agencies should provide guidance explaining what it means for a market maker to be "committed," and how the meaning of that term may vary across different markets and asset classes. For example, we do not believe the Agencies intended to impose a standard whereby a market maker is contractually required to make a market in a security for it to be "committed," because firms do not necessarily have visibility into such arrangements between a market maker and an issuer. Nevertheless, the current text of the regulation creates uncertainty that the Agencies should address.

C. Operational deposits

Under section 4(b)(6) of the U.S. LCR, deposit balances that result from the provision of custody services to a non-regulated fund are categorically excluded from treatment as an operational deposit. We believe that there is no compelling public policy rationale for this exclusion, which is specific to the U.S. LCR and thus represents a gold-plating of the BCBS LCR.

Deposit balances that result from the provision of custody services to a non-regulated fund are derived from the same core services offered to a regulated fund (*i.e.*, safekeeping, settlement and asset administration), and a bank can readily assess these balances using the same operational deposit modeling processes used to assess the eligibility of deposit balances from a regulated fund. Additionally, as with the BCBS LCR, the U.S. LCR excludes prime brokerage services from otherwise eligible operational services (*i.e.*, clearing, custody and cash management services) and clearly defines prime brokerage services.[20] This structure leaves no room for banks to misapply the operational deposit designation to excluded categories of deposits arising from prime brokerage services.

The U.S. LCR's current approach has the perverse effect of making it more difficult for a custodian bank to offer safekeeping, settlement and asset administration services to a non-regulated fund separate from the trading and financing services provided by a third party prime broker. This separation can promote financial stability because it allows a non-regulated fund to diversify its exposure, rather than conducing all of its activities through the same institution.

We therefore urge the Agencies to delete the reference in section 4(b)(6) of the U.S. LCR to "operational services provided to a non-regulated fund," in a manner consistent with the BCBS LCR. The Agencies should also consider recalibrating the outflow rates (in the U.S. LCR) and ASF factor (in the U.S. NSFR) associated with operational deposits to reflect the stability of operational deposit amounts actually observed by firms in periods of stress.

[20] The U.S. LCR states that an operational deposit "must not be provided in connection with the bank's provision of prime brokerage services, which are . . . a package of services offered by the bank, whereby the bank, among other services, executes, clears, settles and finances transactions entered into by the customer, or a third-party entity on behalf of the customer (such as an executing broker), and where the bank has a right to use or re-hypothecate assets provided by the customer, including in connection with the extension of margin and other similar financing of the customer . . . ."

D. Partially insured deposits

Section 3 of the U.S. LCR limits stable retail deposits to retail deposits entirely covered by FDIC deposit insurance. As a result, retail deposits that are only partially insured cannot count as stable retail deposits and, therefore, cannot benefit even partially from a more favorable outflow rate. In contrast, the BCBS LCR allows for the bifurcation of the insured and uninsured portion of retail deposits, treating deposit balances up to the deposit insurance limit as fully insured and therefore as stable retail deposits and any amount in excess as less stable retail deposits.[21] This departure from the BCBS LCR is not justified, especially since the BCBS LCR explicitly addresses deposit insurance subject to a dollar cap, as in the United States.

To illustrate, a non-brokered retail customer deposit balance of $250,000 is subject to a 3 percent outflow under the U.S. LCR, equal to $7,500, on the basis that it is fully insured. If the same retail customer placed an additional $25,000 with the bank, raising the deposit balance to $275,000, the U.S. LCR imposes a 10 percent outflow on the entire balance, equal to $27,500. While the Agencies justified this treatment in the 2014 U.S. LCR final rule preamble citing "supervisory experience," we unaware of any publicly available data that would justify such punitive cliff effects.[22]

The U.S. Treasury report on Banks and Credit Unions, published in June 2017, observes that the U.S. implementation of certain international standards in a manner more stringent than the international standard can make U.S. institutions less competitive globally. The report further observes that regulatory requirements that exceed the international standard can sometimes create an undue burden of higher costs to our economy.[23] We recommend that the Agencies eliminate this gold-plating of the global standard and revise the U.S. LCR treatment of partially insured retail deposits to align with the BCBS LCR.

E. Expansion of HQLA categories

SIFMA supported earlier steps taken by the Agencies to broaden the recognition of financial instruments that can help meet liquidity demand, and we encourage the Agencies to continue to evaluate the liquidity value of assets outside of those originally deemed as HQLA. As the Agencies noted in their final rule that expanded the scope of municipal securities that count as HQLA, "changes to the LCR rule provide covered companies greater flexibility in meeting the LCR rule's minimum requirements by expanding the types of assets that are eligible as HQLA."[24] Consistent with this principle, the Agencies should reassess and update the categories of assets eligible for inclusion in the firm's HQLA to reflect observed market liquidity during stressed conditions.

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[21] BCBS LCR at n. 34.

[22] 79 Fed. Reg. at 61,502.

[23] U.S. Department of the Treasury, *A Financial System That Creates Economic Opportunities: Banks and Credit Unions*, p. 54 (Jun. 2017).

[24] 84 Fed. Reg. 25,975, 25,977 (July 5, 2019)

In addition to impacting a firm's ability to comply with U.S. LCR, the calibration of HQLA categories is also a fundamental component of the U.S. NSFR.[25] The U.S. NSFR implies funding requirements based on HQLA categories; the appropriate calibration of HQLA categories in the U.S. LCR therefore ensures that funding requirements are also appropriately calibrated under the proposed U.S. NSFR.

Below we outline specific considerations to ensure the scope of HQLA reflects an up-to-date and dynamic liquidity pool that a bank can rely upon in times of stress.

1. Review historical price decline test for Level 2B securities

The U.S. LCR requires an equity security qualifying as a Level 2B HQLA security to be "issued by an entity whose publicly traded common equity shares have a proven record as a reliable source of liquidity in repurchase or sales markets during stressed market conditions," demonstrated by evidencing that the market price of the equity security, or market haircut on the equity security in securities borrowing and lending transactions does not exceed prescribed thresholds during a 30 calendar day period of "significant stress." The U.S. LCR does not define the term "significant stress." However, in the context of classifying certain sovereigns and multilateral organization securities as Level 1 HQLA, the preamble to the 2014 final rule provides that this criterion could be met "through reference to historical market prices during times of stress, such as the period of financial market stress experienced from 2007 to 2009."[26]

Based on this language, we do not believe the Agencies intended for firms to consider, in perpetuity, the financial crisis over a decade ago as the relevant period of significant stress. If they had, equities that experienced significant price declines during the financial crisis would presumptively be excluded from HQLA, no matter the date of calculation. In practice, such a point-in-time price decline test would exclude certain securities from HQLA perpetually. Furthermore, such a test could result in only equity securities of young companies qualifying as Level 2B HQLA.

The BCBS clarified in an FAQ that it was not BCBS's "intention . . . to exclude all established companies and include only young companies," and that "determining the appropriate stress period for meeting market performance requirements is a matter of national discretion."[27] Consistent with the BCBS FAQ, the Agencies should issue their own FAQ that confirms that firms may establish frameworks to define periods of "significant stress." Firms could then apply the regulation in a dynamic way that more accurately reflects current market reality and would allow established equities to qualify or requalify as HQLA if they were liquid in a relevant period of "significant stress."

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25 81 Fed. Reg. 35,124 (Jun. 1, 2016).

26 79 Fed. Reg. at 61,456.

27 BCBS, *Basel III – The Liquidity Coverage Ratio framework: frequently asked questions,* ¶ 6(d) (Jun. 2017).

2. Consider shares of investment funds, including mutual funds, money market funds (MMFs), and exchange traded funds (ETFs) as HQLA, specifically where the underlying assets are securities that qualify as HQLA

Investment company shares, such as shares of mutual funds, MMFs, and ETFs do not qualify as HQLA under the U.S. LCR, despite the underlying assets of the fund often exhibiting liquid characteristics. For shares of mutual funds and MMFs, the preamble to the 2014 U.S. LCR final rule notes that "shares of investment companies have been prone to lose value and become less liquid during periods of severe market stress or an idiosyncratic event involving the fund's sponsor."[28] However, fund liquidity risk has been minimized through post-crisis regulatory reforms, including Securities and Exchange Commission ("SEC") requirements for MMFs[29] and other mutual funds[30] to implement enhanced liquidity risk management practices.

As to ETFs, while the preamble to the 2014 final U.S. LCR rule notes that "the agencies believe that the liquidity characteristics of ETFs are not identical to the liquidity characteristics of the underlying index or the individual components of the fund . . . ETFs have their own risk profiles, trading volumes, and market-based characteristics separate from the underlying index,"[31] observed historical performance of ETFs has demonstrated that funds exhibit substantially similar liquid characteristics to those of their underlying indices or individual components. In addition to liquidity generated in the secondary market, ETF liquidity is also supported by primary market arrangements (*i.e.*, redemptions facilitated by authorized participants), which should be considered as part of the liquidity risk profile of these securities. Primary market redemptions can be paid for in cash or "in-kind," whereby an investor receives underlying securities of the ETF, which further aligns the risk profile of ETF shares with their underlying securities.

The Agencies also have not offered any evidence for the proposition that a stress event involving a fund's sponsor could impair the liquidity of the fund. To the contrary, the Financial Stability Oversight Council has recognized that in the case of an investment fund, "third parties' direct financial exposures are often to the issuers of the managed assets, rather than to the nonbank financial company managing those assets."[32]

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[28] 79 Fed. Reg. at 61,465.

[29] The SEC's amendments to the rules governing MMFs have provided MMFs with new tools that can be used to stem heavy redemptions and avoid the type of contagion that occurred during the financial crisis. The SEC now requires institutional prime funds to implement floating net asset values ("NAVs") to eliminate the "first mover advantage" that had incentivized institutional investors to redeem fund shares in times of stress when a MMF's market-based NAV was less than $1.00 per share, making institution funds incapable of "breaking the buck." The SEC's amended rules also provide retail and institutional MMFs the ability to impose liquidity fees and redemption gates. *See* 79 Fed. Reg. 47,736 (Aug. 14, 2014). These enhancements have increased MMF resilience.

[30] The SEC has implemented mutual fund liquidity rules that require the creation of liquidity risk management programs and enhancements to disclosure. *See*, *e.g.*, 81 Fed. Reg. 82,142 (Nov. 16, 2016).

[31] 79 Fed. Reg. at 61,461-62.

[32] 84 Fed. Reg. 9,028, 9,042 (Mar. 13, 2019).

Mutual fund, MMF, and ETF shares should be eligible for inclusion as a Level 2B securities in a firm's HQLA if the firm is able to demonstrate: (1) the ability to look through to the underlying assets of the fund and identify assets that qualify as HQLA, and (2) that the fund exhibits comparable liquidity characteristics of the underlying assets or index, as applicable.

3. Designate Fannie Mae and Freddie Mac securities as Level 1 HQLA until Fannie and Freddie exit conservatorship

Fannie Mae and Freddie Mac securities exhibit similar liquidity characteristics to that of U.S. Treasury securities, which qualify as Level 1 HQLA. However, given that they do not have an explicit full-faith guarantee, they are categorized as Level 2A HQLA securities under the U.S. LCR final rule, and thus are subject to a 15 percent haircut on market value and 40 percent cap on inclusion in a firm's total HQLA.

Agency securities issued by Fannie Mae and Freddie Mac should qualify as Level 1 HQLA until Fannie and Freddie exit conservatorship, consistent with the treatment U.S. Treasuries and securities guaranteed by the full faith of the U.S. Government. Once Fannie Mae and Freddie Mac exit conservatorship, and assuming they no longer are backstopped by the U.S. Government at such time, the Agencies should reevaluate the HQLA categorization of their securities through a notice-and-comment rulemaking.

E. Recognition of contractual substitution rights related to funding transactions

The U.S. LCR considers outflow rates on a secured funding transaction based on the collateral securing the transaction as of the LCR calculation date, and does not consider a firm's contractual ability to substitute the collateral at a future date in the 30-day stress period. In reality, a firm can raise secured funding that can accept a range of securities as collateral. On the calculation date, a firm may pledge a U.S. Treasury in the secured funding trade, but over the course of a 30-day period, a firm with the contractual ability to allocate non-HQLA collateral to the transaction may choose to do so. Such a substitution provides funding for the non-HQLA collateral, and the U.S. Treasury collateral that is no longer pledged again becomes a source of liquidity to the firm.

The contractual ability to substitute collateral allows a firm to use liquidity reserves, in the form of secured funding raised, to offset outflows related to the loss of funding of non-HQLA collateral. Secured funding transactions in which a firm has this contractual substitution ability thus serve as an additional liquidity reserve, outside of HQLA, available to the firm during a stress scenario to satisfy and mitigate outflows.

The U.S. LCR recognizes other analogous forms of liquidity reserves that are contractually or statutorily available to a firm to mitigate outflows in a time of stress. For example, section 33(g) of the U.S. LCR recognizes broker-dealer segregated account inflows, which are another contractual form of funding. Changes in segregated liquid assets create inflows that serve as liquidity reserves available to offset net cash outflows related to customer and collateral positions.

Consistent with the U.S. LCR's general recognition of contractual rights and other forms of non-HQLA liquid reserves, the Agencies should amend the U.S. LCR to recognize an inflow arising from the contractual right to substitute higher-quality collateral with lower-quality collateral in secured funding transactions. Firms already report such contractual substitution rights on secured funding transactions in line S.I.14 of the FR 2052a form, "Other Collateral Substitution Capacity," and this existing reporting would facilitate such an amendment of the U.S. LCR.

F. Recognize priority of firms in deposit sweep programs

Brokered deposit sweeps are subject to a contractual priority waterfall that dictates the order in which deposits are withdrawn. The U.S. LCR provides a lower outflow rate for brokered deposit sweeps from affiliates, in implicit recognition of the effect of the priority waterfall, but fails to recognize the waterfall as to deposits sweeps from unaffiliated firms. Likewise, the 2016 U.S. NSFR proposal, which recognized the reliability of the waterfall in the preamble,[33] would assign a greater funding value to brokered sweep deposits from affiliated institutions, but not to sweeps from unaffiliated institutions.

Importantly, however, the priority waterfall operates regardless of the affiliated status of the deposit broker, and can thus limit outflows arising from certain types of unaffiliated deposit sweeps. We therefore believe the Agencies should re-visit brokered deposit sweep outflow rates to recognize the contractual waterfall priority, whether the sweep comes from an unaffiliated or affiliated firm.

Specifically, in the event that (1) a depository institution has contractual prioritization over other participating depository institutions such that no deposit outflows from its program balance allocation would occur unless 50 percent of the overall program balances are withdrawn (reflecting structural priority), and (2) the contractual agreement has a remaining term greater than one year, then:

- The sweep should be provided the same treatment as an affiliate sweep under section 32(g) of the U.S. LCR (*i.e.*, be eligible for a 10 percent outflow rate); and
- The sweep should be assigned a 90 percent ASF factor under the U.S. NSFR, consistent with an affiliate sweep.

An unaffiliated sweep that does not meet these criteria should continue to receive a 25 percent outflow rate under the U.S. LCR and a 50 percent ASF factor under the U.S. NSFR.

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[33] 81 Fed. Reg. at 35,137 ("A typical brokered sweep deposit arrangement places deposits, usually those in excess of deposit insurance caps, at different banking organizations, with each banking organization receiving the maximum amount that is covered by deposit insurance, according to a priority "waterfall." Within the waterfall structure, affiliates of the deposit broker tend to be the first to receive deposits and the last from which deposits are withdrawn. With this affiliate relationship, a covered company is more likely to receive and maintain a steady stream of brokered sweep deposits. Based on the reliability of this stream of brokered sweep deposits and the enhanced stability associated with full deposit insurance coverage, the proposed rule would treat this type of brokered deposit, in the aggregate, as more stable than brokered sweep deposits received from unaffiliated institutions.").

G. Brokered deposit outflow rates

The U.S. LCR assigns higher outflow rates to brokered deposits than to non-brokered deposits based on a general assumption that brokered deposits pose greater liquidity risk. The concept of brokered deposits, however, is a U.S.-specific regulatory category that is not addressed in the BCBS LCR, and the U.S. LCR further treats brokered deposits in ways that are inconsistent with the statutory categorization of brokered deposits in the Federal Deposit Insurance Act ("FDIA"). Given that the U.S. LCR's current treatment of brokered deposits is grounded in neither the BCBS LCR nor the FDIA, the Agencies have broad discretion to tailor and adjust brokered deposit outflows in the U.S. LCR.

There are two brokered deposit outflow categories where adjustments are warranted. First, as a general matter, there should be greater alignment between the FDIA's definition of "brokered deposit" and brokered deposit-related U.S. LCR outflow assumptions. Where firms have obtained deposit broker waivers from the FDIC, deposits covered by the waiver should not be treated as brokered deposits in the U.S LCR. It undermines regulatory coherence for the FDIC to conclude that valid policy considerations warrant a deposit not being treated as a brokered deposit in one context, while the Agencies simultaneously treat the same deposit as a brokered deposit in the context of calculating U.S. LCR outflow rates.

Second, the brokered deposit sweep program outflow rates in section 32(g) of the U.S. LCR are much higher than is justified by available evidence. Fully insured affiliate sweep deposits, for example, are subject to a 10 percent outflow rate, which is more than three times the outflow rate applicable to non-brokered fully insured stable retail deposits. Fully insured affiliate sweep deposit programs are typically structured within multi-faceted wealth management franchises that involve highly "sticky" customer relationships. We encourage the Agencies to apply a 3 percent outflow rate to fully insured affiliate sweep deposits subject to section 32(g)(7) of the U.S. LCR.

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We appreciate the Agencies' consideration of our concerns. If you have any questions, please contact the undersigned at (202) 962-7327 or cmcdowell@sifma.org.

Respectfully submitted,

Carter McDowell
Managing Director and Associate General Counsel

Annex A: Illustrative EPS Rule Text

12 C.F.R. § 252.35 Liquidity stress testing and buffer requirements.

. . .

(b) *Liquidity buffer requirement.*

. . .

(3) *Asset requirements.* The liquidity buffer must consist of highly liquid assets that are unencumbered, as defined in paragraph (b)(3)(ii) of this section:

(i) *Highly liquid asset.* A highly liquid asset includes:

(A) Cash;

(B) Securities issued or guaranteed by the United States, a U.S. government agency, or a U.S. government-sponsored enterprise; ~~or~~

(C) Any other asset that the bank holding company demonstrates to the satisfaction of the Board:

(*1*) Has low credit risk and low market risk;

(*2*) Is traded in an active secondary two-way market that has committed market makers and independent bona fide offers to buy and sell so that a price reasonably related to the last sales price or current bona fide competitive bid and offer quotations can be determined within one day and settled at that price within a reasonable time period conforming with trade custom; and

(*3*) Is a type of asset that investors historically have purchased in periods of financial market distress during which market liquidity has been impaired~~.~~; or

(D) any other asset that is eligible for inclusion in the bank holding company's HQLA amount for purposes of 12 C.F.R. Part 249.20.