



February 16, 2016

Janet L. Yellen, Chair

Stanley Fischer, Vice Chairman

Daniel K. Tarullo, Governor

Jerome H. Powell, Governor

Lael Brainard, Governor

Board of Governors of the Federal Reserve System
20th and C Streets N.W.
Washington, DC 20551

Dear Chair Yellen, Vice Chairman Fischer and Governors Tarullo, Powell and Brainard:

In follow up to our meeting with Vice Chairman Fischer late last year, the Global Financial Markets Association and the Institute of International Finance appreciate the opportunity to continue our conversation on changing market liquidity.

New regulation was important to address key contributors to the financial crisis. Banks and the broader financial system are safer and sounder today as a result of reforms implemented in the wake of the crisis, including new capital, leverage and funding rules. We appreciate the efforts of the Federal Reserve and other regulators and policy makers in achieving a safer system.

Some reduction in market liquidity is to be expected given the nature and intent of these regulatory reforms. But recent months have seen growing signs of a worrisome reduction in market liquidity, even for the high-quality liquid assets that underpin the entire financial system.

The incentives created by new regulation have significant implications for capital markets activity, particularly for low-risk assets like cash and U.S. Treasuries. These assets are used as collateral for central clearing and other financing transactions by most market participants and as liquidity reserves by small and large banks. Thus, they play a critical role in the smooth functioning of financial markets. While demand for liquidity of these assets is likely lower given more buy and hold investors, market participants continue to expect to be able to quickly liquidate these assets in reasonable size. Therefore, if market participants' ability to generate liquidity through these assets is impaired, particularly during stress periods, it will have ramifications to the functioning of financial markets. Regulations that are risk-insensitive, and regulations that target the same risk multiple times through multiple rules, weigh particularly heavily on low-risk assets.

Similarly, we are concerned that the conflux of multiple regulations on capital markets intermediation by wholesale banks may further reduce end-users' ability to transact, particularly during stressed market conditions. In many markets, banks remain central to wholesale transactions, and hampering their intermediation capacity will necessarily affect their clients' ability to execute trades. Lower liquidity and lack of immediacy facilitated by wholesale banks can result in sharper price dislocations.

Another factor that impacts investors' ability to execute trades and market liquidity more generally is requirements for virtually real-time disclosure of prices and trading volumes, as exist in many markets; similar

rules are being considered for the U.S. Treasury cash market.¹ These transparency rules were designed to foster a more open marketplace. However, in conjunction with the prudential rules and changing market behavior, including reductions in risk appetite and reduced broker-dealer trading – which may occur as broker-dealers reduce support for client activities to avoid disclosing the resulting risk positions to the marketplace in real-time – these rules may have the unintended effect of reducing market depth and weakening market liquidity.

We see the resilience of market liquidity as a critical objective of policymakers and market participants alike. We should collectively turn our attention to an assessment of the coherence of the existing regulatory framework, particularly the treatment of cash and cash equivalents and the calibration of some requirements. Such an assessment could identify opportunities to add liquidity back to the market without adversely affecting the safety and soundness of individual banks or of the overall financial system.

1. The Coherence of the Regulatory Framework

As noted, much necessary work was done post-crisis to improve the risk profiles of major financial institutions and to address existing vulnerabilities in the overall financial system. While the broad contours of the new capital and liquidity rules have been known for some time, the implementation phase is just gathering force and indeed, some rules remain to be proposed and finalized. As such, we believe now is an appropriate time to assess the coherence of the existing framework, or the degree to which multiple rules target the same risks and/or asset classes. The best recommendation would require a broad assessment taking all the current rules into account, including how compliance with one impacts requirements by others. We are thus recommending an assessment of coherence and cumulative impacts, on a forward-looking basis, to identify cases where there may be unnecessary duplication or conflicts between specific regulatory requirements and broader policy goals. In this letter, we ourselves have identified potential, but not exhaustive, areas of concern.

First, we believe that the impact of risk-insensitive rules on client trades that are designed to reduce risk is inconsistent with the policy objectives of capital and prudential regulations. It is important to assess what incentives these risk-insensitive rules will create in distressed markets. Even client transactions that are designed to reduce risk, such as the exchange of a corporate bond portfolio for U.S. Treasuries, will require broker-dealers to expand their balance sheets. Regulations should not impair clients' ability to conduct risk-reducing transactions in cases where these transactions do not substantially add risk to banks' balance sheets. By excluding cash and cash equivalents (including balances held on deposit at central banks) from the Exposure Measure of the Leverage Ratio, and additionally by re-examining their treatment in other relevant regulatory requirements such as the Net Stable Funding Ratio (NSFR), the Federal Reserve could alleviate the constraints on these important market activities, especially in distressed markets.

Second, in looking at the full rule-set today and what we expect to see in the near future, we find duplications and inconsistencies between the rules that together have an undesirable cumulative effect. For instance, the rules designed to prevent funding mismatches are overlapping. The LCR and NSFR significantly mitigate near- and longer-term risks of such funding mismatches, and regulators have widely acknowledged that banks have reduced their reliance on short-term wholesale funding, concurrent with the implementation of new

¹ Federal Register / Vol. 81, No. 14 / Friday, January 22, 2016, [Docket No. TREAS–DO–2015–0013], *Notice Seeking Public Comment on the Evolution of the Treasury Market Structure*, available at: <https://www.treasury.gov/press-center/press-releases/Documents/Market%20Structure%20RFI%20Final.pdf>

prudential standards.² Yet other rules target the same funding activity as well. The GSIB Method 2 methodology, for example, does not consider firms' LCR or NSFR compliance, meaning that liquidity risk is addressed twice through separate and unaligned standards. Potential revisions to CCAR to incorporate GSIB buffers into post-stress minimums would address this risk a third time.

Additionally, and related to our first point, the treatment of low-risk, high-quality assets like cash and cash equivalents varies depending on the rule and often does not reflect their low-risk or risk-free status. For example, while Treasury securities receive a 5% or 6% capital charge under the eSLR, the NSFR imposes a 10% funding charge on reverse repos secured by Treasuries, making it difficult to provide financing against such high-quality, cash-equivalent assets.³

Finally, the assessment should examine the calibration of specific rules that are designed to serve as backstops but that instead operate as binding constraints, and do so in light of the cumulative impact of the full set of rules. One example is the Fundamental Review of the Trading Book (FRTB) and its interplay with the proposed standardized floors and TLAC.

Despite BCBS's reiteration not to significantly increase risk based capital requirements, trading book capital will increase by 40% under the new rules based on the BCBS's impact assessment.⁴ Our concern is that the FRTB, coupled with standardized floors will lead to significant RWA increases for trading activities in key asset classes. Furthermore, higher RWAs would also increase banks' TLAC requirements, compounding the effect. We worry that the overall impact will have a disproportionate effect on dealer banks and result in further reduction in capital markets intermediation, market liquidity and ultimately higher financing costs to end-users.

We believe the duplication and conflict among the many new rules were not necessarily intended, impede traditional activities, and can be addressed and mitigated without undermining safety and soundness of individual banks or the overall financial sector.

2. Regulations and Market Liquidity: Implications for Investors and Issuers

Where new regulations such as the leverage ratio and NSFR interact with other rules and changes in market structure to further reduce market liquidity, users of financial services could be prevented from achieving their investing, capital-raising or risk-management goals, undermining the critical role of capital markets in the economy. While it has been observed^{5,6} that the average size of trades has already shrunk during the implementation of the post-crisis regulatory reform program, indicating less immediacy of execution and higher execution costs in most asset classes, investors have shown an ability to absorb some of the execution risks in day-to-day markets. However, under the new rules they may not be able to transact effectively in stressed markets, when the need to sell is acute and delays can drive sharper price dislocations. We provide illustrative transactions below.

² See, e.g., Chair Janet L. Yellen, "Improving the Oversight of Large Financial Institutions" (Mar. 3, 2015) (noting that large U.S. banks' "reliance on short-term wholesale funding has dropped considerably" since the financial crisis), available at: <http://www.federalreserve.gov/newsevents/speech/yellen20150303a.htm>.

³ BCBS, *The net stable funding ratio*, (Oct. 2014), p. 38: "Unencumbered loans to financial institutions with residual maturities of less than six months, where the loan is secured against Level 1 assets as defined in LCR paragraph 50, and where the bank has the ability to freely rehypothecate the received collateral for the life of the loan."

⁴ BCBS press statement, *Revised framework for market risk capital requirements issued by the Basel Committee*, (14 January 2016): Compared with the current market risk framework, the revised market risk standard would result in a median (weighted mean) increase of approximately 22% (40%) in total market risk capital requirements. Available at <http://www.bis.org/press/p160114.htm>

⁵ IMF Global Stability Report, October 2015 (pg 62) https://www.imf.org/External/Pubs/FT/GFSR/2015/02/pdf/text_v3.pdf

⁶ PwC Global Financial Markets Liquidity Study August 2015 (for GFMA & IIF) (pgs 51, 54, 60-63, 77, 88-89, 91) <http://www.pwc.com/gx/en/industries/financial-services/publications/financial-markets-liquidity-study.html>

In ‘normal’ markets, swift execution isn’t always necessary: sellers can afford to wait until they find a buyer who wants to buy exactly the assets they want to sell, and vice versa. Investors typically trade ‘like-for-like’ within discrete asset classes, selling equities in one sector to buy equities in another, for example, or exchanging one portfolio of corporate bonds for another.

In a market sell-off, time is of the essence and ‘like-for-like’ matching is difficult, especially for illiquid assets. Wholesale banks’ client-focused business models, expertise as intermediaries, capital position and balance sheet capacity allow them to provide immediacy and flexibility - eliminating the need for an immediate but difficult-to-achieve ‘like-for-like’ match between end-users.

Risk-averse investors wishing to reduce their exposures and risk-seeking investors seeking a buying opportunity will both be impacted by the new restrictions on banks’ ability to intermediate. As a result, volatility is likely to increase and sell-offs are likely to be longer-lasting and more severe than they would have been in the past. Issuers may be temporarily prevented from issuing debt or equity, or may have to bear substantially higher issuing costs. Making derivatives more expensive increases the cost of hedging, which raises costs to investors and corporates, or can drive corporates not to hedge, which can increase volatility in their earnings.

To see how the consequences of reduced liquidity could play out, consider a set of transactions that typically occur in a stressed market. A mutual fund wishes to reduce its market exposure by selling a balanced portfolio of equities and corporate bonds and to put the resulting cash on deposit at a bank until markets stabilize. A pension fund sees market weakness as a buying opportunity and wants to shift its own portfolio of low-risk assets to riskier assets (conveniently in our example the same assets that the mutual fund is selling to reduce its exposure).

Both the mutual fund and the pension fund rely on bank intermediation to facilitate their transactions quickly. The mutual fund sells its risky portfolio to the broker-dealer subsidiary of a bank and puts the proceeds of the sale on deposit, either with the same bank or another. The bank holds the risky assets on its balance sheet, and hedges them, until it can find a buyer.

Unless the pension fund has significant cash on hand, it too will need to turn to a bank, using Treasuries or other low-risk assets as collateral against a loan from a bank. The pension fund then uses the borrowed cash to buy the original portfolio of risky assets from the bank, which in turn can unwind its hedges as the position is removed from its balance sheet.

The new rules create several difficulties for these otherwise ordinary transactions.

The first is that a bank may not be able to purchase the risky assets from the mutual fund if the bank is already near its capital and liquidity requirements – which most major banks are today. For banks constrained by CCAR or Basel III RWA, under which higher-risk assets carry a higher capital charge than cash does, they might not have the ‘extra’ capital needed to support these new assets. Raising fresh equity in a stressed market would be impractical. Alternatively, the bank could liquidate other capital-intensive assets in order to absorb the purchase from the mutual fund, but this would take time – time that the client may not want to wait – and could exacerbate market selling pressure on a broader range of assets.

Alternatively, the mutual fund might prefer to hedge its market position rather than to liquidate it. To do so it would, for example, take a short position on an ETF. However, to facilitate this client risk-reducing position, a broker dealer would need to hold a long position on the ETF and hedge it with, for example, a short futures position. For the bank, both the long ETF and short futures positions will consume balance sheet capacity based on the SLR calculations. In addition they will require higher required stable funding and a higher level of HQLA to meet the NSFR and LCR requirements. This result is particularly worrisome as markets have seen evidence of

increased demand for ETF instruments in times of high volatility. With respect to hedging broker-dealer inventory, new rules, including exposure calculations, liquidity and market-risk capital rules, make hedging expensive, and if the hedging derivative is not clearable then initial margin requirements can be very costly. Both the cost and the feasibility of hedging weigh on the bank's ability to add a risk position to its portfolio – even when it is doing so in order to facilitate clients' risk-reduction.

A further difficulty is the risk that the bank might not be able to accept the deposit of the cash that results from the mutual fund's sale of its portfolio. Again, a bank that is capital-constrained by the SLR might simply lack the capacity to increase the size of its balance sheet, regardless of the assets' risk profile. Here too, raising incremental capital during distress would be impractical. And even if the bank did have the capacity to accept the deposit, the fact that non-operating deposits from other financial institutions carry a 100% charge under the LCR means that the deposit would need to be held in low-yielding HQLA. The combination of these requirements could make the client's deposit economically unaffordable for the bank.

In order to facilitate the client transaction while mitigating the impact on its SLR, the bank might opt to sweep the client cash to a money market fund rather than hold it on its own balance sheet. As with other steps in this transaction, this would become considerably more difficult in a stressed market. As banks and clients move cash into money market funds, these funds could find that they prefer not to hold the cash. Any market rush to Treasuries would push down Treasury yields and likely increase the number of failed deliveries in the repo market. Market participants may not have sufficient access to Treasuries either. While the Fed's reverse repo facility is a potential direct access point, not all mutual funds have access to the facility and the facility is capped. If Treasury yields fall and costs rise, money market funds may, like banks, avoid accepting more cash. Indeed, the dislocation in the cash and Treasury markets could also reduce the effectiveness of monetary policy.

Finally, new rules may prevent the bank from making a secured loan to the pension fund that wants to buy the original asset. Repo and secured lending transactions are discouraged by a host of new rules, including Basel III (which overstates RWA values under the Standardized Approach), the SLR (which imposes high capital charges on low-risk assets), the LCR (which applies severely conservative haircuts) and the GSIB surcharge (which penalizes short-term wholesale funding activity). In this environment, banks operating close to their capital and liquidity requirements may not be able to lend, even against ultra-safe Treasuries.

Given the importance of banks in facilitating clients' trades and the real risks that banks will not be able to act as intermediaries in stressed markets, we encourage the Federal Reserve to consider a broad assessment of the coherence of the regulatory framework to address such concerns which are not in conflict with safety and soundness. We believe that the intent of the new regulation is to address leverage, bank balance sheet liquidity and loss absorption capacity, but not to impede the ability of firms to facilitate core client activities.

3. Specific recommendations

These are just a few of the examples highlighting the importance of an internally coherent regulatory framework. With that in mind, in this section we suggest potential steps the Federal Reserve could take to improve market liquidity without adversely affecting the safety and soundness of individual firms or the broader financial system.

a. Coherence in treatment of safe assets: Exclusion of cash and U.S. Treasury securities from the total leverage exposure and examination of treatment in other rules

The eSLR is an important component of the post-crisis regulatory regime. However, we believe that two technical revisions are warranted, in the form of exclusions for cash and for near-cash assets like unencumbered U.S. Treasury securities. This would improve market liquidity, but because cash and Treasury holdings do not

increase banks' risk profiles, and because banks are compliant with the LCR (and hence safe from the liquidity standpoint), it would also not adversely affect safety and soundness. Moreover, as noted earlier, funding mismatches are also separately addressed in the GSIB rulemaking and NSFR, making a third constraint unnecessary.

b. Coherence across rulemakings

Given the monetary policy backdrop and where we are in the process of implementing the post crisis regulatory reform package, we think this is an appropriate time to assess the coherence of the overall regulatory framework. This assessment would allow regulators to evaluate the interaction of existing regulations with an eye toward the rulemaking that is still underway or yet to come. Two areas of future rulemaking could serve as examples for improvement:

(i) GSIB buffers into CCAR

The Federal Reserve has indicated that it is currently considering whether to incorporate GSIB buffers into the Capital Analysis and Review (CCAR) process.⁷ In our view, the CCAR process and GSIB rule are already largely duplicative in their objectives. Furthermore, the factors driving the GSIB surcharge calculation focus overwhelmingly on the proportion of bank balance sheets that relate to wholesale funding and market making activities. Thus, a principal way for a GSIB to lower its score is to reduce its wholesale and capital markets activities. Combining the GSIB surcharge with CCAR clearly magnifies the impact and increases this incentive, and would further drive trading firms to reduce their inventories.

(ii) Implementation of the NSFR

We recommend that the Federal Reserve consider how to appropriately implement the NSFR in the U.S. While we support the NSFR's underlying policy goal of promoting funding stability, we believe it is not fully coherent with other parts of the regulatory framework, especially with regard to the treatment of cash and cash equivalents. For example, the treatment of shorter-dated funding secured by U.S. Treasury securities seems inconsistent with assumptions in the U.S. GSIB rule.⁸ Similarly, calibration differences exist among other liability-focused prudential standards (TLAC, GSIB rule, LCR) that make it challenging to align banks' ALM practices with regulatory standards.⁹

c. Calibration in light of cumulative impact of the full set of rules

Despite BCBS's reiteration not to significantly increase overall capital requirements further through its 2016 work program, the FRTB represents another substantial increase in capital requirements for capital markets intermediation. When assessing the coherence of the new rules against other existing and proposed regulatory initiatives, it is critical to take into account the broad ranging changes in the regulatory pipeline as well as the

⁷ 80 Fed. Reg. 49082, 49,093 (Aug. 14, 2015); 79 Fed. Reg. 75,473, 75,482 (Dec. 18, 2014).

⁸ The U.S. GSIB rule assigns 0 percent short-term wholesale funding weighting to 3-6 month funding secured by U.S. Treasury securities, including when such funding is received from a financial institution counterparty, effectively recognizing such funding as stable. By contrast, the BCBS NSFR assigns no available stable funding (ASF) recognition to 3-6 month funding secured by U.S. Treasury securities when the counterparty is a financial institution.

⁹ The Federal Reserve's TLAC proposal imposes a penalty when TLAC-eligible liabilities have less than two years' remaining maturity. By contrast, the BCBS NSFR gives full funding credit to all liabilities with one year or greater remaining maturity, but disqualifies most funding with less than six months' remaining maturity. The U.S. GSIB rule, in turn, provides for tiered recognition of funding sources with less than six months' maturity across 0-1, 1-3 and 3-6 month maturity periods. While the U.S. LCR requires firms to measure a 30-day stressed period derivatives outflows amount, the NSFR's derivatives methodology incorporates a gross measure of derivatives liabilities without reference to maturity.

interconnectedness of the framework components. For instance, standardized floors and lower leverage requirements address to a degree the same risks while the higher FRTB RWAs (floored or not) will have an impact on the RWA based TLAC requirements. We recommend that the FRTB rules are carefully assessed on asset class/ product levels during the BCBS mandated monitoring period and amended where required to avoid the rules unduly constraining market liquidity without systemic stability benefits. More generally, risk weights should be appropriately risk sensitive for all capital rules.

Additionally, the Federal Reserve may contemplate minor accommodations in the NSFR to support capital markets activities. In particular, such accommodations may include applying a consistent netting standard across derivatives assets and liabilities, addressing cliff effects in secured funding transactions, and incorporating sensible asset-liability management principles for interdependent transactions, such as by excluding client-funded assets (e.g., broker-dealer lock-up cash) from banks' RSF calculations.

To reiterate, we agree that the various regulatory reforms introduced since the financial crisis each had their own rationales, and that enhanced strength and stability of the financial system is a shared objective of the industry and policy-makers alike. We similarly have a shared responsibility to understand the cumulative impacts and mitigate adverse consequences for critical market functions and the economy.

We appreciate the opportunity to offer our thoughts on these important issues. More broadly, we would welcome the opportunity to continue this dialogue and to explore other possible interactions among the new rules, their potential causes and policy tools which might be used to mitigate them.

Sincerely,



Kenneth E. Bentsen, Jr.
CEO
Global Financial Markets Association (GFMA)



Timothy D. Adams
President and CEO
Institute of International Finance (IIF)