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The Basel Committee Strikes Again: Long-Term Liquidity Rules*

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Since the 2008 financial panic, the Basel Committee on Banking Supervision appears to have become the "super regulator" for establishing bank supervisory policies in the United States. The Basel Committee is composed of bank supervisory authorities and central bankers from selected counties, including EU member nations, Japan, Hong Kong, Singapore, Indonesia, Russia, China, Saudi Arabia and Turkey. Representatives of these countries, along with the United States, meet regularly in Basel, Switzerland to develop the rules that will apply to internationally active banks around the world. Unfortunately, these rules, developed by representatives of these varied countries, do not always represent prudent policy for the financial system in the United States. Further, although the Basel agreement is written with the large, internationally active banks in mind, the U.S. regulators have been applying these requirements to smaller and smaller institutions, often with only minor modifications. The recent proposal to implement a Basel requirement relating to liquidity provides a good example of this problem.

In October of 2014, the Basel Committee reached an agreement among its numerous members to implement a long-term liquidity requirement, called the Net Stable Funding Ratio (NSFR). U.S. implementation officially began on June 1, when the U.S. banking agencies published a proposed regulation in the Federal Register to make the agreement applicable to all U.S. banking organizations (both depository institutions and holding companies) with consolidated assets of $250 billion or more, or with $10 billion or more in consolidated on-balance sheet foreign exposures. In addition, the U.S. banking agencies decided to impose a modified version to smaller banking organizations that have at least $50 billion in assets, even if these institutions do not engage in international activities. Thus, once again, the Basel standards designed for larger banks operating internationally is likely to be imposed on regional banks with as little as $50 billion in assets. It would not be surprising if a version of this requirement is eventually extended to smaller banks.

The Basel agreement and the proposed regulation require covered banking organizations to hold cash or assets readily convertible into cash (such as U.S. Government or foreign government debt) in an amount sufficient to meet liquidity needs for a one-year period of economic stress. Banks can satisfy the liquidity requirements through less pristine assets, such as GSE mortgage-backed securities, or retail mortgages, but only after reducing the value of such assets through prescribed haircuts.

To compute the necessary amount of liquidity needed, covered companies are given "run off" rates

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for their current funding sources. These "run off" percentages are called "ASF factors." For example, a covered institution must assume that 10 percent of its fully insured deposits will run off during the stress period, 50 percent of its deposits that are not fully insured will run off, and all uninsured brokered deposits will be withdrawn.

The next step is to determine the amount of cash that could be raised by selling off assets held by the covered company. The regulation does this by assigning discounts to the assets held by the covered banking organizations, calculating the amount of existing commitments that will have to be funded, and calculating a net position for derivative exposures. For example, the regulation would allow a covered bank to count the entire amount of its cash on hand and bank reserves held by a Federal Reserve Bank, 50 percent of its portfolio of investment grade corporate debt securities, and 45 percent of its portfolio of prudently underwritten retail mortgages loans with a remaining maturity of one year or more.

The difference between the computed amount of liquidity needed after considering the prescribed run off percentages, and the amount of cash that the institution can raise by selling its assets during the stress period, represents the amount of additional liquidity the banking company must hold. For larger banking organizations, 100 percent of this difference must be made up by adjusting the organization's balance sheet. For banks between $50 billion and $250 billion, a modified rule applies, and the banking organization needs to adjust its balance sheet to ensure than 70 percent (rather than 100 percent) of the expected cash needs will be available during the stress period.

One area in which the Basel framework does not work well for U.S. institutions concerns the treatment of Federal Home Loan Bank (FHLBank) loans or "advances" to member institutions and FHLBank debt obligations. Perhaps because these institutions are unique to the United States, the international agreement does not take the characteristics of these special institutions into account. As a result, the proposed regulation makes little sense in how it deals with the assets and liabilities related to these entities.

The proposed rule assigns Federal Home Loan Bank advances a 50 percent run off rate. This is the same run off rate that applies to private sector commercial lenders. This ignores the congressionally mandated public purposes of the FHLBank System and the history of the FHLBanks as a type of "lender of last resort" for mortgage lenders. In fact, at the height of the financial crisis, in 2008 to 2009, the Federal Home Loan Bank System provided more liquidity to U.S. institutions than the Federal Reserve Banks. Rather than withdrawing funding, the Banks fulfilled its statutory mission of providing liquidity. The proposed rule disregards these facts.

The proposal also discounts the value of the debt issued by the Federal Home Loan Bank System, which are the consolidated obligations of all the FHLBanks. Covered companies would be required to apply a 15 percent discount to the book value of their portfolio of these consolidated obligations. In other words, the proposal requires covered companies to assume that they would only be able to sell these notes at a sharp discount to their book value during a financial panic. This again ignores recent history. In the panic that began in 2008, market demand for Federal Home Loan Bank System obligations increased, and these obligations traded very close to Treasuries. Requiring covered companies to discount the value of their portfolio of these obligations is simply not consistent with recent experience of how markets treat these obligations.

Neglecting the value of FHLBank advances and obligations will have a significant adverse impact on our financial system, and will likely raise costs to consumers. The reason is simple. Currently, a banking organization can borrow significant funds from an FHLBank at a competitive interest rate, and use these funds to make new mortgage loans. The mortgage loans yield more than the cost of the advances, and therefore are profitable investments for the member banks. Under the proposal, a bank seeking to borrower $100 million from a FHLBank would also have to deal with a regulatory need to find an additional $50 million in liquidity due to the projected "run off" rate on such advances. This could not be accomplished by simply making $100 million in new mortgages, since the proposed regulation only gives 45 percent liquidity credit to mortgages, and only if they have at least a year to maturity. The shortfall will have to be made up, and the most efficient method would be to hold additional cash or Treasury obligations.

This problem is compounded by the fact that in order to obtain a $100 million advance, the covered company has to pledge at least 100 million in mortgage assets to the Federal Home Loan Bank. Under the proposal, the existence of this lien would be viewed as an "encumbrance," thereby reducing (if the encumbrance has between 6 months and 1 year remaining) or eliminating (if the encumbrance has more than 1 year remaining) the ability to use these mortgage assets to satisfy the liquidity requirement. This further penalizes a covered company from using low cost Federal Home Loan Bank advances to finance mortgage loans, in direct contradiction to the Congressional purpose in establishing these Banks. And as a result, could easily result in less mortgage availability of higher mortgage costs to the public.

In sum, the current trend toward using the Basel Committee to establish regulatory policy in the United States needs to be acknowledged and then re-thought. The United States has a unique financial system with thousands of depository institutions, holding companies, and specialized entities, as well as specialized institutions such as the Federal Home Loan Banks created by Congress for specific purposes. The majority of the countries sitting on the Basel Committee have far different systems, and the decisions that they are making may not be the best for the U.S. and its financial system. The punitive treatment of Federal Home Loan Bank advances and debt obligations provides a good illustration of this problem.

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