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The U.S. Federal Banking Agencies to Require Large Banks to Maintain a Liquidity Coverage Ratio

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In this article, the authors explain a recent proposal by U.S. federal banking agencies to require banking firms with at least $50 billion in total consolidated assets to maintain a 100 percent liquidity coverage ratio.

The U.S. federal banking agencies have issued a proposal to require banking firms with at least $50 billion in total consolidated assets to maintain a 100 percent liquidity coverage ratio ("LCR").[1] The proposed rule is intended to be consistent with the LCR standard that the Basel Committee on Banking Supervision has established for large, global banks as part of the Basel III liquidity framework. But one obvious deviation is that the U.S. proposal would apply a modified LCR requirement to some firms that are not internationally active. Although U.S. bank regulators previously have addressed liquidity in examination ratings and reserve requirements, and as a prudential matter on an *ad hoc* basis, the LCR rule would be the first quantitative liquidity requirement formally included in U.S. banking regulations.

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APPLICABILITY

The standard LCR requirement in the proposed rule is designed to help ensure that banks have sufficient liquidity to survive a 30-calendar-day stress period. It would apply to a depository institution or depository institution holding company with $250 billion or more in total consolidated assets or $10 billion or more in total on-balance sheet foreign exposure, as well as a consolidated subsidiary depository institution of such a banking firm that has $10 billion or more in total consolidated assets. It would also apply to a nonbank financial company that the Financial Stability Oversight Council has designated for supervision by the Federal Reserve Board.

The modified LCR requirement would require sufficient liquidity for a 21-calendar-day stress period — essentially requiring banks in the $50 to $250 billion size range to maintain 70 percent of the full liquidity requirements applicable to the largest banks. It would apply to a depository institution holding company that has $50 billion or more in total consolidated assets but would not be subject to the standard LCR requirement.

A savings and loan holding company with substantial insurance underwriting or commercial activities would not be subject to the LCR requirement; nor would a bank holding company or nonbank financial company with substantial insurance underwriting activities.

Most banking organizations with less than $50 billion in consolidated assets are not subject to the proposed LCR requirement.

THE LCR REQUIREMENT

The proposed rule would require a bank to calculate its LCR on each business day, as of the same time, which the bank would need to select before the effective date.[2] The LCR would be calculated as the bank's high-quality liquid asset ("HQLA") amount divided by its total net cash outflow amount. The minimum LCR requirement would be one, which means the bank's HQLA amount must be no less than its total net cash outflow amount. The LCR is designed to help ensure short-term liquidity as its calculation is based on a 30-calendar-day stress period, as discussed below.

HIGH-QUALITY LIQUID ASSETS

The proposed rule identifies three classes of HQLAs and lays out the criteria for each class. It describes the criteria that HQLAs must meet to be included in a bank's HQLA amount, the operating requirements that a bank must meet to include HQLAs in its HQLA amount, and the limits on including level 2 liquid assets in the HQLA amount.

Criteria for Each Class of HQLAs

The proposed rule provides for three classes of HQLAs, based on the counterparty or issuer: level 1 liquid assets, level 2A liquid assets, and level 2B liquid assets.

Level 1 liquid assets would generally consist of central bank reserves that the bank may freely use, as well as securities issued or unconditionally guaranteed by the U.S. Treasury. Level 1 liquid assets would also include liquid and readily marketable securities issued or unconditionally guaranteed by foreign sovereign entities or certain multilateral organizations, and assigned a zero percent risk weight under the regulatory capital rules (but a zero percent risk weight would not be required if the sovereign issued the securities in its own currency, and the bank holds the assets to meet its liquidity needs in that jurisdiction).

Level 2A liquid assets would generally consist of investment-grade debt securities issued or unconditionally guaranteed by a U.S. government-sponsored enterprise; and securities issued or guaranteed by a foreign sovereign entity or multilateral development bank that are assigned a 20 percent or lower risk weight under the regulatory capital rules. Level 2A liquid assets would need to be liquid and readily marketable.

Level 2B liquid assets would generally consist of publicly traded corporate debt securities that are liquid, readily marketable, and investment-grade; and publicly traded common equity shares included in the Standard & Poor's 500 Index or a similar index, and issued in the U.S. dollar or a currency in which the bank has liquidity needs.

In addition, level 2A liquid assets (other than GSE debt) and level 2B liquid assets would need to be issued by entities whose obligations have proven to be a reliable source of liquidity in repurchase or sales markets during

stressed market conditions, as demonstrated by the market price declining, or the market haircut increasing, by no more than 10 percent for level 2A assets, 20 percent for corporate debt securities, and 40 percent for common equity shares, during a 30-calendar-day stress period.

Further, a security cannot be a level 1, level 2A, or level 2B liquid asset if its issuer is a financial sector entity, *i.e.*, a regulated financial company, non-regulated fund, SEC-registered investment company, SEC-registered investment adviser, or pension fund (or a consolidated subsidiary of any such company). A regulated financial company is defined broadly to include any financial firm supervised by a U.S. federal banking agency, insurance company, SEC-registered broker or dealer, futures commission merchant, swap dealer, or security-based swap dealer (or any similarly regulated foreign financial firm). A non-regulated fund is defined as any hedge fund or private equity fund whose investment adviser is required to file SEC Form PF and any consolidated subsidiary of such a fund, other than a small business investment company ("SBICs").

Deposits of SBICs and deposits of private investment funds that are not subject to SEC Form PF filings — such as certain venture capital funds whose advisers are exempt from registration with the SEC under the Investment Advisers Act, some (but not all) real estate funds and mortgage pools, and other investment pools that are not required to be registered with the SEC under the Investment Company Act but do not rely on Sections 3(c)(1) or 3(c)(7) for an exemption from that Act — are treated relatively favorably as deposits of non-financial entities under the proposed LCR rule.

The identity of Form PF filers is not publicly available, making an analysis of deposits of private funds under the proposed rule a challenge. Data in SEC Form ADV can be used to make a reasonable estimate as to whether a private fund is the subject of a Form PF filing, but not with complete certainty. In addition, the terms "hedge fund" and "private equity fund" are not defined, leaving room for further clarification in the final rule.

Generally Applicable Criteria for HQLAs

HQLAs, as described above, would still need to meet the following criteria to be included in a bank's HQLA amount:

- The assets are unencumbered (which means that the bank is free to convert them into cash) and not pledged (except that assets may be pledged to a central bank or a U.S. GSE to secure unused borrowing capacity);
- The assets are not client pool securities or related cash;
- Assets held in a consolidated subsidiary of the bank could be included in the HQLA amount up to the amount of net cash outflows of the subsidiary plus any additional amount available for transfer to the bank during times of stress without statutory, regulatory, contractual, or supervisory restrictions;
- Assets that the bank received under a re-hypothecation right could not be included if the beneficial owner has a contractual right to withdraw the assets without remuneration at any time within 30 calendar days following the calculation date; and
- Assets designated to cover operational costs could not be included.

Limits on Including Level 2 Liquid Assets in the HQLA Amount

The proposed rule would allow a bank to include the full fair value of its level 1 liquid assets in the HQLA amount. It would apply a 15 percent haircut to level 2A liquid assets and a 50 percent haircut to level 2B liquid assets, which means that a bank could include level 2A liquid assets in its HQLA amount at 85 percent of fair value (as determined under GAAP) and level 2B liquid assets at 50 percent of fair value. Further, the proposed rule would cap the amount of level 2 liquid assets (*i.e.*, the sum of level 2A and level 2B liquid assets) at 40 percent, and level 2B liquid assets at 15 percent, of a bank's HQLA amount.

The application of these haircuts and caps would require two calculations. The first calculation would assume that the bank would unwind none of its secured funding transactions, secured lending transactions, asset exchanges, or collateralized derivatives transactions that would mature within 30 calendar days following the calculation day. The second calculation would assume that the bank would unwind all such transactions, which would require the exchange of HQLAs between the bank and its counterparties and thus change the composition of the bank's HQLAs. The first calculation would yield the bank's unadjusted excess HQLA amount, and the second calculation would yield the bank's adjusted excess HQLA amount. The greater of these two amounts would be deducted from the bank's HQLA amount.

Operational Requirements

To include an HQLA in its HQLA amount, a bank would need to:

- have the operational capability to convert the HQLA into cash;
- implement policies that require all HQLAs to be under the control of its liquidity management function (which must evidence control over the HQLAs);
- maintain policies and procedures that determine the composition of the assets in its HQLA amount; and
- include in its total net cash outflow amount the amount of cash outflows that would result from the termination of any specific hedge against HQLAs included in its HQLA amount.

TOTAL NET CASH OUTFLOW AMOUNT

Under the standard LCR requirement in the proposed rule, a bank would need to calculate its net cumulative cash outflows (i.e., cumulative cash outflows minus cumulative cash inflows, except that cumulative cash inflows would be capped at 75 percent of cumulative cash outflows) for each of the

30 calendar days following the calculation date. The largest daily amount over this 30-day period would be the total net cash outflow amount used in the LCR calculation.

Cash Outflow Categories

Under the proposed rule, the outflow amount for each category of funding or commitment would be calculated as the outstanding balance multiplied by the applicable outflow rate. The categories and associated outflow rates are summarized below.

1. Unsecured retail funding outflow amount: The outflow rate would be three percent for stable retail deposits or 10 percent for all other retail deposits. These outflow rates would apply to retail deposits regardless of maturity. A retail deposit would mean a demand or term deposit placed by a retail customer or counterparty and would not include "brokered deposits" as defined for purposes of the Federal Deposit Insurance Act. A stable retail deposit would be a retail deposit that is fully insured and either (a) held in a transactional account or (b) made by a depositor that has another established relationship with the bank, such that withdrawal of the deposit in reaction to liquidity stress would be unlikely.
2. Structured transaction outflow amount: With respect to a structured transaction for which the bank is a sponsor, the outflow amount would be the greater of (a) 100 percent of the amount of all debt obligations of the issuing entity that mature, and all commitments made by the issuing entity to purchase assets, within 30 calendar days following the calculation date, or (b) the maximum amount of funding the bank may be contractually required to provide to the issuing entity within 30 calendar days following the calculation date.
3. Net derivative cash outflow amount: The net derivative cash outflow amount would equal the sum of the payments and collateral that the bank will make or deliver to each counterparty under derivative transactions within 30 calendar days following the calculation date less, if subject to a valid qualifying master netting agreement, the sum of payments and collateral due from each counterparty during this period.

4. Mortgage commitment outflow amount: A 10 percent outflow rate would apply to all retail mortgage commitments that can be drawn upon within 30 calendar days following the calculation date.
5. Commitment outflow amount: The proposed rule would apply outflow rates ranging from zero percent to 100 percent to the undrawn portion of committed credit facilities and liquidity facilities provided by the bank to its customers that can be drawn down within 30 calendar days following the calculation date. The outflow rate would depend on the counterparty, with higher rates for facilities committed to financial sector entities (other than an affiliated depository institution) or special purpose entities.
6. Collateral outflow amount: The collateral outflow amount would be the amount of additional collateral that the bank is required to post.

The collateral outflow amount would be calculated as the sum of the following amounts:

a. Changes in financial condition: The bank would need to count as an outflow 100 percent of all amounts that it is contractually required to post as additional collateral as a result of a change in its financial condition.
b. Potential valuation changes: The proposed rule would apply a 20 percent outflow rate to the fair value of any collateral posted by the bank that is not level 1 liquid assets to account for the likely devaluation of the collateral, as a result of which the bank would be required to post additional collateral to its counterparties.
c. Excess collateral: The proposed rule would apply a 100 percent outflow rate to the fair value of any collateral posted by counterparties that exceeds the current collateral requirement.
d. Contractually required collateral: The proposed rule would apply a 100 percent outflow rate to the fair value of collateral that the bank is contractually required to post but has not yet posted.

e. Collateral substitution: The bank would need to include in the outflow amount the differential in post-haircut fair value between HQLA collateral posted by a counterparty and lower-quality HQLA or non-HQLA that the counterparty may substitute under an applicable contract.

f. Derivative collateral change: The bank would need to include in the outflow amount the absolute value of the largest cumulative net mark-to-market collateral outflow or inflow over 30 consecutive calendar days resulting from derivative transactions realized during the preceding 24 months.

7. Brokered deposit outflow amount for retail customers or counterparties: Different outflow rates would apply to reciprocal brokered deposits, brokered sweep deposits, and other brokered deposits.

Outflow Rates Applicable to Different Types of Retail Brokered Deposits

a. Reciprocal brokered deposits: The proposed rule would apply a 10 percent outflow rate to all reciprocal brokered deposits that are fully insured, and a 25 percent rate to those not fully insured. These outflow rates would apply to reciprocal brokered deposits that have no contractual maturity date. For those that have a contractual maturity date, the actual cash outflows due to maturity during the 30-calendar-day stress period would be included in the outflow amount.

b. Brokered sweep deposits: The proposed rule would assign outflow rates to brokered sweep deposits based on whether the deposits are fully insured and whether the broker sweeping the deposits is an affiliate of the bank. It would apply a 10 percent outflow rate to deposits that are fully insured and swept by an affiliated broker, a 25 percent rate to deposits that are fully insured but swept by an unaffiliated broker, and a 40 percent rate to deposits that are not

fully insured. These outflow rates would apply to brokered sweep deposits that have no contractual maturity date. For those that have a contractual maturity date, the actual cash outflows due to maturity during the 30-calendar-day stress period would be included in the outflow amount.

c. All other brokered deposits: For retail brokered deposits that are neither reciprocal brokered deposits nor brokered sweep deposits, the proposed rule would apply a 10 percent outflow rate if they mature later than 30 calendar days from the calculation date, or otherwise a 100 percent rate.

8. Unsecured wholesale funding outflow amount: The outflow rates assigned to unsecured wholesale funding would generally be based on the purpose of the funding, deposit insurance coverage, and the counterparty. These outflow rates would apply where there is no contractual maturity date. For funding that has a contractual maturity date, the actual outflows due to maturity during the 30-calendar-day stress period would be included in the outflow amount.

Outflow Rates Applicable to Unsecured Wholesale Funding

a. Unsecured wholesale funding that is an operational deposit: Lower outflow rates would apply to operational deposits, which are deposits that the bank's customers maintain as a condition to using the bank's operational services, such as clearing, custody, and cash management services. Deposits of an SEC-registered investment company or investment adviser, or a non-regulated fund, would not qualify as operational deposits; nor would certain overnight deposits owned by another depository institution for which the bank serves as a correspondent bank. The outflow rate would be five percent for operational deposits (excluding escrow accounts) that are fully covered by deposit insurance, or 25 percent for those not fully insured.

b. Unsecured wholesale funding that is not an operational deposit: The proposed rule would apply a 100 percent outflow rate to unsecured wholesale funding that is not an operational deposit, if it is provided by a financial sector entity. For such funding provided by a non-financial sector entity, the proposed rule would apply a 20 percent rate if the entire amount is covered by deposit insurance and not a brokered deposit, or otherwise a 40 percent rate.

9. Debt security outflow amount: Where a bank is the primary market maker for its own debt securities, the proposed rule would apply a three percent outflow rate to those debt securities that are not structured securities and a five percent rate to those that are. These outflow rates would apply to securities that mature outside the 30-calendar-day stress period. For securities that mature within the 30-day period, the bank would include the actual cash outflows due to the maturity of the securities.
10. Secured funding and asset exchange outflow amount: The secured funding outflow rates would range from zero percent to 100 percent to account for the risk that the bank could be required to provide additional collateral or higher-quality collateral to support a given level of secured debt. The asset exchange outflow rates would range from zero percent to 100 percent to account for the risk that the bank would be contractually obligated to provide higher-quality assets in return for less liquid, lower-quality assets.
11. Foreign central bank borrowings: For borrowings from a foreign central bank, the outflow rate would be the rate established by the foreign jurisdiction for central bank borrowings under its minimum liquidity standard. If the foreign jurisdiction has not established such an outflow rate, the bank would apply the outflow rates for secured funding under the U.S. rule.
12. Other contractual outflow amounts: The proposed rule would generally apply a 100 percent outflow rate to amounts payable within 30 days of the calculation date under applicable contracts.

Total Cash Inflow Amount

The proposed rule would exclude from the total cash inflow amount a bank's operational deposits held at other regulated financial companies, credit or liquidity facilities extended to the bank, assets included in the bank's HQLA amount and any amount payable to the bank with respect to such assets, assets that are nonperforming as of the calculation date or reasonably expected to become nonperforming within 30 calendar days following the calculation date, and payments from forward sales of mortgage loans or derivatives that are mortgage commitments. Payments with no contractual maturity date or payable to the bank more than 30 calendar days following the calculation date also could not be included in the total cash inflow amount.

The proposed rule would include the following amounts payable to the bank within 30 calendar days after the calculation date in the total cash inflow amount:

- Net derivative cash inflow amount, which would equal the sum of payments and collateral that the bank will receive from each counterparty under derivative transactions, less the sum of payments and collateral that it will make or deliver to each counterparty (if subject to a qualifying master netting arrangement).
- Retail cash inflow amount, which would equal 50 percent of all payments contractually payable to the bank from retail customers.
- Unsecured wholesale cash inflow amount, which would equal 100 percent of all payments payable by financial sector entities or central banks, plus 50 percent of all payments contractually payable by wholesale customers that are not financial sector entities.
- Securities cash inflow amount, which would include 100 percent of all contractual payments due to the bank on securities it owns that are not HQLAs.
- Secured lending cash inflow amount, which would range from zero percent to 100 percent of contractual payments due to the bank pursuant to secured lending transactions to recognize the bank's contractual right to require additional or higher-quality collateral from borrowers to support a given level of secured debt.

- Asset exchange cash inflow amount, which would range from zero percent to 100 percent of the fair value of HQLAs that the bank will receive from a counterparty pursuant to asset exchanges to recognize the bank's contractual right to deliver less liquid, lower-quality assets to the counterparty in return for higher-quality assets.

LCR SHORTFALL

If a bank's LCR falls below the required level, it would be required to notify its primary federal regulator. If its LCR remains below the required level for three consecutive business days, or if the supervisor otherwise determines the bank to be materially noncompliant with the LCR requirement, the bank would be required to submit a plan for achieving compliance.

TRANSITIONS

The LCR requirement would become effective on January 1, 2015. The required LCR would be 0.8 in 2015, 0.9 in 2016, and 1.0 beginning on January 1, 2017.

MODIFIED LCR

The modified LCR requirement would be based on a 21-calendar-day stress scenario. A bank subject to the modified LCR requirement would calculate its LCR generally in the same manner as under the standard LCR requirement, with several differences. First, the bank would use a 21-calendar-day period (as opposed to a 30-calendar-day period) in calculating its HQLA amount. Second, the bank would use 70 percent of each outflow and inflow rate for outflows and inflows without a contractual maturity date, and would include outflows and inflows occurring within 21 calendar days (as opposed to 30 calendar days) following the calculation date for those with a contractual maturity date. Third, under the modified LCR requirement, the bank's total net cash outflow amount would be the difference between its total outflow amounts and total inflow amounts during a 21-calendar-day stress period, as opposed to the largest daily net cumulative outflow amount

during a 30-calendar-day stress period.

Banks may face significant operational challenges in implementing the LCR requirement. Banks with $250 billion or more in consolidated assets will face the most significant challenges, while banks in the $50 to $250 billion size range will need to address its requirements to a slightly lesser degree. To comport with the final rule, affected banks will need to model the impact of the LCR rule, reassess their funding sources and asset mix, and restructure their balance sheets. Coordination among bank staff from different functions will be necessary. It is not too early to start planning even though the final rule may still be months away.

NOTES

[1] Liquidity Coverage Ratio: Liquidity Risk Measurement, Standards, and Monitoring; Proposed Rule, 78 Fed. Reg. 71818 (Nov. 29, 2013). Separately, the Federal Reserve issued a final rule to establish enhanced prudential standards for large bank holding companies and foreign banking organizations on February 18, 2014. The rule requires U.S. bank holding companies with total consolidated assets of $50 billion or more to hold a buffer of highly liquid assets based on projected funding needs during a 30-day stress event. Foreign banking organizations with combined U.S. assets of $50 billion or more will need to meet the same requirement for their intermediate holding companies, but their U.S. branches and agencies need only maintain a liquidity buffer for days 1 through 14 of a 30-day stress scenario. Unlike the proposed LCR requirement, these liquidity buffer requirements are based on the banking organizations' own stress tests. Federal Reserve Board, Enhanced Prudential Standards for Bank Holding Companies and Foreign Banking Organizations (February 18, 2014), http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20140218a1.pdf.

[2] We refer to any company subject to the proposed rule as a bank in this article.