Liquidity Coverage Ratio; Liquidity Risk Management Standards – Final Rule of U.S. Bank Regulators

Executive Summary

The Federal Reserve Board (Federal Reserve), the Office of the Comptroller of the Currency (OCC), and the Federal Deposit Insurance Corporation (FDIC) (collectively, the Agencies) have jointly released a final rule to implement in the United States (U.S.) a quantitative liquidity requirement for large, internationally active banking organizations. The final rule is substantially similar to the Agencies' proposed rule published in November 2013 (please refer to Regulatory Practice Letter 13-20), though some adjustments (detailed below) have been made based on comments received. It becomes effective January 1, 2015; Compliance is subject to a phase-in scheduled.

In final form, the quantitative liquidity requirement imposes the expectation that, on a consolidated basis, a company's "unencumbered high-quality liquid assets" (HQLAs) are at least equal to 100 percent of its "total net cash outflows" over a prospective 30-calendar-day period. The ratio of the company's liquid assets to its projected net cash outflows is referred to as its "liquidity coverage ratio" (LCR).

Companies covered by the final rule generally include, bank holding companies (BHCs), certain savings and loan holding companies (SLHCs), and depository institutions with $250 billion or more in total consolidated assets or more than $10 billion in on-balance sheet foreign exposure, and their consolidated depository institution subsidiaries with $10 billion or more in total consolidated assets (Covered Companies). BHCs and SLHCs without significant insurance or commercial operations that have $50 billion or more in total consolidated assets and are not otherwise companies covered by the LCR final rule, will be subject to a modified LCR requirement by the Federal Reserve (Modified LCR HCs).

The final rule becomes effective January 1, 2015 though transition schedules have been introduced to provide for compliance and reporting frequency:

- Covered Companies with $700 billion or more in total consolidated assets or $10 trillion or more in assets under custody, and their consolidated depository institution subsidiaries with $10 billion or more in total consolidated assets must calculate the LCR on a monthly basis between January 1, 2015 and June 30, 2015, and on a daily basis thereafter.
- All other Covered Companies must calculate the LCR on a monthly basis between January 1, 2015 and June 30, 2016, and on a daily basis thereafter.
- Modified LCR HCs must calculate the Modified LCR on a monthly basis beginning January 1, 2016.

- All Covered Companies must achieve at least: 80 percent of the minimum LCR in 2015, 90 percent of the minimum LCR in 2016, and 100 percent of the minimum LCR in 2017 and thereafter.
- Modified LCR HCs must achieve at least 90 percent of the minimum Modified LCR in 2016, and 100 percent of the minimum Modified LCR in 2017 and thereafter.

Key Changes from the Proposed Rule

The final rule is substantially similar to the proposed rule though some modifications have been made to respond to the comments received. Key adjustments include:

- Changes to the range of corporate debt and equity securities included in HQLA;
- Imposition of a phase-in period for the daily calculation requirements;
- Revisions to the approach to address maturity mismatch during a 30-day period;
- Withdrawal of nonbank financial services companies designated by the Financial Stability Oversight Council (Council) and their consolidated depository institution subsidiaries from the scope of Covered Companies; and
- Changes in the Modified LCR related to the stress period, calculation frequency, and implementation timeline.

Key Takeaways

- The final rule provides relief to all Covered Companies and Modified LCR HCs in terms of the **implementation timeline** and the **frequency of the calculation** (at least initially).
  - The largest Covered Companies, those with more than $700 billion in total consolidated assets or $10 trillion in assets under custody including certain consolidated subsidiaries) will **report monthly** instead of daily for the first six months.
  - A **new category** of Covered Companies (i.e., those with total consolidated assets between $250 billion and $700 billion) will receive relief in terms of the initial reporting **frequency** (month-end for 18 months). This approach is generally consistent with the break points provided in the recently finalized *Complex Institution Liquidity Monitoring Report and Liquidity Monitoring Report* (i.e. Reporting form FR 2052).
  - Modified LCR HCs (i.e., those with assets between $50 billion and $250 billion) will receive a one year **delay** for compliance and will only report **monthly** rather than daily using a 30 day stress period.
- The scheduled delays will help banks take a more **strategic approach** to developing systems to address the LCR calculation.
- The final rule more closely resembles the LCR standard established by the Basel Committee on Banking Supervision (Basel Committee) as a component of the Basel III capital framework.
- The regulators appear to have considered the **operational challenges** facing banks who are building the environments to create these calculations by providing delays for certain Covered Companies and Modified LCR HCs, adjusting initial frequency of reporting for all entities, and aligning the stress horizons for Modified LCR HCs by changing the 21-day period to 30-days.
  - We have seen in some cases, that month-end LCRs can be 10 to 15 points higher than intra-month LCRs.

Background

In February 2014, the Federal Reserve approved a new Regulation YY that establishes enhanced prudential standards for U.S. BHCs with total consolidated assets of $50 billion or more and foreign banking organizations (FBOs) with total global consolidated assets of more than $50 billion or more. The standards include liquidity risk management standards, internal liquidity stress testing requirements, and the maintenance of a liquidity buffer. The rule does not apply to nonbank financial services companies designated by the Council for supervision by the Federal Reserve but the Federal Reserve intends to apply enhanced prudential standards to these institutions through a subsequently issued order or rule following evaluation of the business model, capital structure, and risk profile of each designated nonbank financial company.

The LCR is intended to be generally consistent with the liquidity coverage ratio standard established by the Basel Committee as a component of the Basel III capital framework (Basel III LCR). The Basel III LCR requirement will be introduced on January 1, 2015 at 60 percent of the minimum requirement and will rise in equal annual steps of 10 percentage points to reach 100 percent on January 1, 2019. The phase-in arrangement is intended to align with the Basel III capital adequacy requirements. Once fully implemented, the 100 percent threshold of the Basel III LCR is to serve as a minimum requirement in normal times. In its final form, the LCR continues to be more stringent than the Basel III LCR, including the range of assets that qualify as HQLA, the assumed rate of outflows of certain kinds of funding, and the shorter transition period to full implementation. The Agencies estimate, however, that approximately 70 percent of Covered Companies and Modified LCR HCs would currently meet an LCR requirement of 100 percent if the final rule were currently effective and fully phased-in.

Description

LCR Requirement

The final rule retains the structure of the LCR requirement as proposed. Covered Companies must maintain a ratio of unencumbered HQLAs (the numerator of the ratio) to total net cash outflows (the denominator of the ratio) that is no less than 100 percent over a prospective 30-calendar day period (the 30-day stress period).

The final rule continues to be applicable to BHCs, certain SLHCs, and depository institutions with more than $250 billion in total consolidated assets or more than $10 billion in on-balance sheet foreign exposure, and their consolidated depository institution subsidiaries with $10 billion or more in total consolidated assets, as calculated in their most recent year-end regulatory reports. These Covered Companies are now divided into two reporting categories (see below). The Federal Reserve has retained its requirement to apply a Modified LCR to BHCs and SLHCs without significant insurance or commercial operations that have $50 billion or more in total consolidated assets and are not otherwise companies covered by the LCR rule.

In finalizing the LCR rule, the Agencies clarified the rule would not apply to:

- Nonbank financial services companies designated by the Council for supervision by the Federal Reserve or their consolidated subsidiary depository institutions (as had been proposed); or
- FBOs and their U.S. Intermediate Holding Companies (IHCs).

Implementation

Consistent with the proposal, the final rule imposes a three-year transition period that begins January 1, 2015. Covered Companies must comply with a minimum LCR of 80 percent throughout calendar year 2015. Between January 1, 2016, and December 31, 2016, the minimum LCR would be 90 percent; Beginning January 1, 2017 and thereafter, all Covered Companies must maintain a minimum LCR of 100 percent.

The final rule, however, introduces new reporting categories and reporting frequencies:

- Covered companies with $700 billion or more in total consolidated assets or $10 trillion or more in assets under custody, and their consolidated depository institution subsidiaries with $10 billion or more in total consolidated assets must calculate the LCR on a monthly basis for a six-month period between January 1, 2015 and June 30, 2015, and on a daily basis beginning July 1, 2015 and thereafter.
- All other Covered Companies (those with total consolidated assets of $250 billion or more but less than $700 billion) must calculate the LCR on a monthly basis for an eighteen month period between January 1, 2015 and June 30, 2016, and on a daily basis beginning July 1, 2016 and thereafter.

Monthly calculations are to be made as of the last business day of a calendar month.

Banking organizations that meet the assets thresholds for Covered Companies as of September 30, 2014 must comply with the rule beginning January 1, 2015. Companies that meet the assets thresholds after September 30, 2014 based on the applicable regulatory year-end report, must comply with the final rule beginning April 1 of the following year. Newly Covered Companies must calculate their LCR on a monthly basis between April 1 and December 31 of the initial reporting year and daily beginning January 1 of the following year. Banking organizations that become subject to the final rule as the result of an agency determination must comply with the rule in a manner consistent with the transition specified by the agency.

HQLA (High Quality Liquid Assets)

Consistent with the proposed rule, there are three categories of HQLAs: Level 1; Level 2A; and Level 2B. Level 2A and 2B Assets are subject to haircuts from fair value of 15 percent and 50 percent, respectively. They are further limited as a percent of the total HQLA, such that together Level 2A and 2B Assets may not comprise 40 percent of the total HQLA and Level 2B Assets alone may not exceed 15 percent of the HQLA.

The final rule generally adopts the qualifying criteria and specific requirements for particular assets classes under the HQLA structure though with some modifications, including:

- Clarifying that a Covered Company may monetize assets through repurchase transactions in addition to outright sales.

- Clarifying that a Covered Company should be able to demonstrate to its primary federal supervisor its security-by-security analysis showing that the HQLA it holds meet the "liquid and readily marketable standard."
- Revising the definition of a "non-regulated fund" to exclude consolidated subsidiaries of hedge funds and private equity funds whose investment adviser is required to file Securities and Exchange Commission Form PF.
- Removing a requirement that corporate debt securities must be publicly traded on a national securities exchange.
- Adjusting the scope of U.S. equities that may be included in Level 2B Assets to include the common equity securities of companies listed in the Russell 1000 index in place of companies listed in the S&P 500.
- Clarifying that the amount of outflow resulting from the termination of a hedging transaction should be deducted from the fair value of the applicable eligible HQLA rather than included as an inflow in the LCR denominator.
- Adopting the proposed exception that an asset may be considered unencumbered if the asset is pledged to a central bank or a U.S. GSE (government sponsored enterprise) to secure potential borrowings and credit secured by the asset has not been extended to the Covered Company or its consolidated subsidiaries. The Agencies clarify this provision applies to assets the Company is required to pledge to receive access to payment services.
- Clarifying that any asset that a Covered Company received with rehypothecation rights would not be considered eligible HQLA if the counterparty that provided the asset, or the beneficial owner, has a contractual right to withdraw the asset without paying non-de-minimus remuneration at any time during the 30 calendar days following the calculation date.

As of each calculation date, the HQLA would equal:

- Level 1 Assets – equal to the fair value of all eligible HQLA Level 1 Assets less the Covered Company's reserve balance requirement[1], *plus*
- Level 2A Assets (adjusted for a 15 percent haircut from fair value), *plus*
- Level 2B Assets (adjusted for a 50 percent haircut from fair value),
- *Minus* the greater of:
  - The unadjusted excess HQLA asset amount – which would be equal to the sum of the Level 2 cap excess amount and the Level 2B cap excess amount on the first day of the 30-day stress period, without unwinding any transactions, and
  - The adjusted excess HQLA asset amount – which would be equal to the sum of the Level 2 cap excess amount and the Level 2B cap excess amount at the end of the 30-day stress period after unwinding all secured funding transactions, secured lending transactions, asset exchanges, and collateralized derivatives transactions, each as defined by the proposed rule, that mature within a 30-day stress period where HQLA is exchanged.

The final rule does not require a Covered Company to unwind certain secured funding transactions that are collateralized deposits, as defined in the rule, when determining the adjusted HQLA amount.

The final rule defines "collateralized deposits" as either: 1) a deposit of a public sector entity held at the Covered Company that is secured under applicable law by lien on assets owned by the Covered Company and that gives the depositor, as holder of the

[1] Specifically, the reserve balance requirement under Section 204.5 of Regulation D.

lien, priority over the assets in the event the Covered Company enters into receivership, bankruptcy, insolvency, liquidation, resolution or similar proceeding, or 2) a deposit of a fiduciary account held at the Covered Company for which the Covered Company is a fiduciary and sets aside assets owned by the Covered Company as security and that gives the depositor priority over the assets in the event the Covered Company enters into receivership, bankruptcy, insolvency, liquidation, resolution or similar proceeding.

Total Net Cash Outflows

To address commenters concerns, the Agencies have modified the net cash outflows calculation by:

- Modifying the proposed net cumulative peak day approach to use an "add-on" approach:
  - First – cash inflows and outflows over the 30-day calendar period are aggregated and netted against one another, with the aggregated inflows capped at 75 percent of the aggregated outflows.
  - Second – the "add-on," determined to be the largest single-day maturity mismatch within the 30-day calendar period, is calculated.
  - Third – these amounts are added together to calculate Total Net Cash Outflows.
- Changing the provisions for determining maturity mismatch within the 30-calendar day stress horizon to focus "more explicitly on outflows and inflows with contractual maturity dates as well as overnight funding from financial institutions."[2]

Certain outflow rates, among others, were changed to:

- Establish that the unsecured funding transaction outflow rate for a whole counterparty would be the maximum outflow rate for that counterparty.
- Apply a 100 percent outflow rate only to specific purpose entities (SPEs) that rely on market funding.
- Add certain collateral and payment processing services provided by Covered Companies to the definition of operational services that result in lower outflow rates. In addition, deposits related to services in providing custody banking services as agent or administrator would qualify for lower output rates.

Shortfall Provisions

Consistent with the proposed rule, Covered Companies are expected to maintain an LCR at or above 100 percent at all times.[3] On any business day that a Covered Company's LCR falls below 100 percent, it must notify its primary Federal supervisor. If the LCR is below 100 percent for three consecutive business days, the Covered Company is required to submit to its primary Federal supervisor a plan for remediation of the shortfall. A Covered Company could also be required to submit a remediation plan whenever its primary Federal supervisor determines it is "materially noncompliant" with the provisions of the rule.

The LCR is a minimum requirement and Covered Companies whose liquidity stress testing (conducted under the enhanced prudential standards requirements) indicates a

[2] Staff memo to the Federal Reserve Board, pg 7.

[3] During the transition period, a shortfall would be an LCR below 80 percent in 2015 and below 90 percent in 2016.

need for higher liquidity reserves may need to take steps in addition to meeting the minimum LCR to meet supervisory expectations.

Forthcoming Actions

The Agencies state they will be considering additional regulatory actions related to the LCR.

- Nonbank companies and their consolidated subsidiary depository institutions will be subject to an LCR requirement by separate rule or order of the Federal Reserve. Following the designation of a nonbank financial services company for supervision by the Federal Reserve, the Federal Reserve intends to assess the business model, capital structures, and risk profile of the designated company, looking at "nature, scope, size, scale, concentration, interconnectedness, mix of the activities" along with other risk-related factors to determine how the enhanced prudential standards and the LCR requirement might be tailored for application to the company. The company will receive notice and opportunity to provide comment prior to the Federal Reserve's determination of any LCR requirement.
    - Once a designated nonbank becomes subject to the LCR requirement, its subsidiary depository institutions with total consolidated assets of $10 billion or more will also become subject to the rule.
- The Agencies anticipate "implementing an LCR-based standard through a separate rulemaking for the U.S. operations of some or all foreign banking organizations with $50 billion or more in combined U.S. assets." FBOs and U.S. IHCs of FBOs are not covered by the final rule.
- A proposed rule governing regulatory reporting requirements and instructions relating to the disclosure of a Covered Company's LCR will be forthcoming.
- A proposed rule that would implement a Net Stable Funding Ratio (NSFR) consistent with the Basel Committee's Basel III Liquidity Framework will follow the Basel Committee's adoption of a final international rule for the NSFR.
- Proposed rules may be released to expand the assets eligible for the HQLA, including certain state and municipal securities as well as central bank restricted committed facility capacity.

Modified LCR

The Federal Reserve has retained its proposal to apply a Modified LCR to BHCs and SLHCs that do not have significant insurance or commercial operations, have $50 billion or more in total consolidated assets, and are not otherwise a Covered Company. The requirement will be applied as an enhanced prudential standard.

Changes to the Modified LCR provisions included in the final rule:

- Increase the stress period under which the net cash outflows are to be calculated from 21 days to 30 days (they will continue to be multiplied by 70 percent);
- Delay the implementation schedule to January 1, 2016 (rather than January 1, 2015); and
- Require Modified LCR HCs to report on a monthly basis (rather than daily) beginning January 1, 2016 and thereafter.

The final rule also clarifies that a Modified LCR HC is required to comply with the Modified LCR on the first day of the quarter following the date at which the average total consolidated assets of the HC equals or exceeds $50 billion.

Commentary

On the whole, it appears the Agencies have considered the operational challenges facing both Covered Companies and Modified LCR HCs as they work to build the infrastructures needed to comply with the LCR calculation and anticipated reporting requirements.

The Agencies acknowledge that the largest of the Covered Companies are currently submitting daily liquidity reports. In addition, they have estimated that 70 percent of all Covered Companies and Modified LCR HCs could currently meet the fully phased-in 100 percent LCR requirement. Accordingly, the imposition of a six-month monthly reporting period for the largest Covered Companies (generally those over $700 billion in total consolidated assets), and an eighteen-month monthly reporting period for the remaining Covered Companies (generally those with total consolidated assets between $250 billion and $700 billion) provides an opportunity for these entities to develop strategies to best address the LCR calculation.

For Modified LCR HCs, the introduction of a monthly reporting frequency using month-end LCRs should diminish volatility that could have resulted from the proposed intra-month LCR calculations. Also, month-end measures tend to be higher points of liquidity, in some cases by as much as 10 to 15 points.

Much discussion was given to whether some types of state and municipal securities should be eligible assets for HQLA. The Federal Reserve staff and Federal Reserve Governor Tarullo were both supportive of, and recommended release of, a proposed rule to identify a criteria for determining those state and municipal bonds that are comparable to liquid corporate bonds and so might be considered for inclusion in HQLA. FDIC Chairman Gruenberg said only that they would "monitor the impact of the final rule on municipal securities and consider adjustments, if necessary."

Governor Tarullo remains concerned about short-term wholesale funding issues and anticipates further rulemaking to address them, including rules to: implement in the U.S. a long-term liquidity requirement consistent with the Basel Committee's NSFR (when completed); add short-term wholesale funding as a component in calculating risk-based capital surcharges for the largest globally active U.S. banks; and impose minimum collateral haircuts on securities financing transactions.

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