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Legal Update
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The US Banking Regulators Propose a Liquidity Coverage Ratio For Large Banking Organizations and Systemically Important Non-Banks

On October 24, 2013, the Board of Governors of the Federal Reserve System (FRB) approved a proposed rule (the Proposed Rule) to strengthen the liquidity positions of large financial institutions. For the first time, the Proposed Rule would create a standardized minimum liquidity requirement (namely, a minimum liquidity coverage ratio or LCR). The Proposed Rule's LCR was described as "super-equivalent" to the Basel counterpart rule by FRB Governor Daniel Tarullo in his introductory remarks.

Following soon therafter, on October 30, 2013, the Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency each approved a joint "substantially identical" proposed rule.

Comments on the Proposed Rule are due by January 31, 2014. Once adopted by the FRB, the rule will be Regulation WW.

The Proposed Rule would apply to banking organizations with $250 billon or more in total assets or $10 billion or more in on-balance sheet foreign exposures, as well as to non-bank financial institutions designated "systemically important" by the Financial Stability Oversight Council (Standard LCR Companies). As described below, a different version of the LCR with a 21-day stress period and a reduced outflow test would apply to depository institution holding companies with total consolidated assets of $50 billion or more that are not internationally active (Modified LCR Companies and, together with Standard LCR Companies, LCR Covered Companies). In addition, the Proposed Rule gives the FRB authority to apply the Proposed Rule's LCR requirement (US LCR) to other companies if the FRB concludes that to do so would be appropriate based on the asset size, level of complexity, risk profile, scope of operations, affiliation with foreign or domestic banking organizations or risk to the "financial system."

The US LCR generally follows the LCR requirement (Basel LCR) as revised and adopted by the Basel Committee on Banking Supervision (Basel Committee) of the Bank of International Settlements last January, but it is more stringent in several important respects, which are highlighted below.

The Basel LCR is one of the Basel Committee's key reforms to strengthen global capital and liquidity regulations with the goal of promoting a more resilient banking sector. The Basel LCR is intended to promote the short-term resilience of a bank's liquidity risk profile by ensuring that a bank has an adequate stock of unencumbered high-quality liquid assets (HQLA) that can be converted into cash easily and immediately in private markets to meet its liquidity needs for a 30-calendar-day liquidity stress scenario. The Basel Committee believes that the Basel LCR will improve the banking sector's ability to absorb shocks arising from financial and economic stress, whatever the source, thus reducing the risk of spillover from the financial sector to the real economy.

Both the Basel LCR and the US LCR are prescribed as the ratio of two components:

- A **numerator** consisting of *the value of the stock of HQLA* and
- A **denominator** consisting of *the total net cash outflows for a specified period in a stress scenario*.

Under the Proposed Rule, the specified stress period for Standard LCR Companies is 30 calendar days, while for Modified LCR Companies it is 21 calendar days.

For both the Basel LCR and the US LCR, the minimum LCR requirement is that the LCR equal or exceed 1.0 (i.e., 100 percent).

For the Basel LCR, HQLA are comprised of Level 1 and Level 2 assets. Level 1 assets generally include cash, central bank reserves and certain marketable securities backed by sovereigns and central banks. These assets are typically of the highest quality and the most liquid, and there is no limit on the extent to which a bank can hold these assets to meet the LCR. Level 2 assets are comprised of Level 2A and Level 2B assets. Level 2A assets include certain government and public sector enterprise securities, covered bonds and corporate debt securities rated "AA" (or equivalent) or higher. Level 2B assets include lower-rated corporate bonds, residential mortgage backed securities (subject to a 15 percent haircut) and equities that meet certain conditions. Level 2 assets may not, in aggregate, account for more than 40 percent of a bank's stock of HQLA. Level 2B assets may not account for more than 15 percent of a bank's total stock of HQLA. In order to qualify as HQLA, assets should be liquid in markets during a time of stress and, in most cases, be eligible for use in central bank operations (e.g., repo or discount window facilities). Certain types of assets within HQLA are subject to a range of haircuts. Significantly, HQLA was expanded by the Basel Committee in January 2013 following complaints that the original December 2010 definition was too conservative and risked harm to the real economy.

The denominator of the Basel LCR is the total net cash outflows, which is defined as total expected cash outflows minus total expected cash inflows in the specified stress period for the subsequent 30 calendar days. Total expected cash outflows are calculated by multiplying the outstanding balances of various categories or types of liabilities and off-balance sheet commitments by the rates at which they are expected to run off or be drawn down. Total expected cash inflows are calculated by multiplying the outstanding balances of various categories of contractual receivables by the rates at which they are expected to flow in. Total cash inflows are subject to an aggregate cap of 75 percent of total expected cash outflows, thereby ensuring a minimum level of HQLA holdings at all times.

The Proposed Rule differs from the Basel LCR in several material respects. These include the following:

- **Accelerated Transition Period for LCR Compliance.**

  Under the Proposed Rule, LCR Covered Companies and Modified LCR Companies will be required to comply with the US LCR requirement by January 1, 2017, with phased-in compliance of 80 percent by January 1, 2015 and 90 percent by January 1, 2016.

  In contrast, the Basel LCR requires 60 percent compliance by January 1, 2015 and a 10 percent per year increase until 100 percent compliance by January 1, 2019.

  As a result, the Proposed Rule will be fully effective two years before the Basel LCR.

- **Peak Net Outflow Day Test**

  Under the Proposed Rule, LCR Covered Companies would be required to hold HQLA to cover the highest net cumulative cash flow for any day within the applicable stress period.

Under the Basel LCR, only HQLA to cover the net cumulative cash flow for that period is required.

- **More Restrictive HQLA Definition**

  By effectively rejecting last January's expansion of HQLA for the Basel LCR, the Proposed Rule defines HQLA more restrictively (and much closer to the original HQLA definition under the Basel LCR when first published in December 2010).

  However, consistent with the Basel LCR, under the Proposed Rule, HQLA are generally required to be liquid and readily marketable, a reliable source of funding in repo or sales markets, and not an obligation of a financial company.[1] The Proposed Rule divides HQLA into three categories based on the nature of the asset and the related issuer, with specified caps and haircuts on some categories. The amount of an HQLA is its fair value regardless of its value for financial reporting purposes. The Proposed Rule's three HQLA categories are:

  – **Level 1 liquid assets** are the highest quality and most liquid assets and include (i) excess reserves held at the Federal Reserve; (ii) withdrawable reserves held at a foreign central bank; (iii) securities issued by, or guaranteed by the full faith and credit of, the US government; and (iv) certain securities that are claims on, or claims guaranteed by, a sovereign entity, a central bank or another international entity that is assigned a 0 percent risk weight[2] under the standardized approach of the revised regulatory capital rules. Level 1 liquid assets may be included in the HQLA amount without limit due to their consistently highly liquid nature.

  – **Level 2A liquid assets** include claims on, or claims guaranteed by, a US government-sponsored enterprise (GSE)[3] and claims on, or claims guaranteed by, a sovereign entity or a multilateral development bank that are assigned a 20 percent risk weight under the standardized approach of the revised regulatory capital rules. Level 2A liquid assets generally demonstrate a high level of liquidity, but due to their characteristics, they may be at higher risk for liquidity impediments than Level 1 liquid assets. They are, therefore, subject to a 15 percent haircut under the Proposed Rule and may only comprise 40 percent of total HQLA when combined with level 2B liquid assets.

  – **Level 2B liquid assets** generally include: (i) investment grade, publicly traded corporate debt securities issued by an entity whose obligations have a proven record as a reliable source of liquidity in repurchase or sales markets during stressed market conditions, demonstrated by (a) the market price of the publicly traded corporate debt security or equivalent securities of the issuer declining by no more than 20 percent during a 30-calendar-day period of significant stress, or (b) the market haircut demanded by counterparties to secured lending and secured funding transactions that are collateralized by the publicly traded corporate debt security or equivalent securities of the issuer increasing by no more than 20 percentage points during a 30-calendar-day period of significant stress; and (ii) publicly traded equities that are included in the Standard & Poor's 500 Index or an equivalent index that meets the satisfaction of the relevant supervisor. Because these securities are subject to significantly higher risk of loss of liquidity due to idiosyncratic or market-wide factors, they would be subject to a 50 percent haircut and may only comprise 15 percent of total HQLA.

With the specific exception of Level 2B corporate debt securities, the Proposed Rule is generally silent on the criteria to be used to determine that assets are sufficently liquid and readily marketable in times of stress for HQLA purposes apart from a general statement that the HQLA is traded in an active secondary market with more than two committed market-makers and a large number of noncommitted market-maker participants that both buy and sell, with timely and observable market prices and a high trading volume. As a result, it is relatively unclear what other or additional criteria the banking regulators might use for this requirement.

Under the Proposed Rule, the caps (40 percent and 15 percent) are calculated both before and after giving effect to an assumed unwind of any HQLA-for-HQLA transaction (i.e, a repo or swap) that could occur in the specified stress period, with the lower being used for the HQLA amount.

In addition, a company cannot include in its consolidated HQLA amount any qualifying assets held by its subsidiaries in excess of the amount of the net cash outflows of the subsidiaries, unless the assets can be transferred to the company without statutory, regulatory, supervisory or contractual restrictions.

In recommending the Proposed Rule, the FRB staff noted that securities issued and guaranteed by GSEs have historically been highly liquid even in times of stress. However, their obligations are not as liquid as US Treasuries, and, consequently, the FRB staff recommended that they not be included in Level 1 liquid assets.

Certain banks had hoped to get the FRB to include GSE assets in Level 1 liquid assets (i.e., without having to be haircut) and will be disappointed in the proposed treatment as Level 2A liquid assets under the Proposed Rule. Similarly, some banks will be disappointed at the apparent exclusion of high-quality ABS from Level 2B liquid assets (even with the haircut/cap) and the apparent exclusion of even some US government-guaranteed assets (e.g., FFELP ABS, which are substantially, but not wholly, guaranteed). The Basel revisions of HQLA last January were driven, at least in part, by concerns about the availability of sufficient Level 1 liquid assets, although most US private label RMBS would not meet the conditions for inclusion as qualifying RMBS under the current Basel LCR.

Under the Proposed Rule, the total net cash outflow amount would include the difference between a company's total stressed cash outflow and inflow amounts, which would be calculated by applying standard rates based on a 30- or 21-day liquidity stress scenario, as applicable, to the balances of the company's funding sources. The Proposed Rule's outflow and inflow rates are designed to distinguish stable funding sources (such as retail deposits) from those that are more volatile (such as financial institution deposits). For Modified LCR Companies, 70 percent of stressed outflows are used.

The US LCR is to be calculated on a daily basis leaving uncertain the treatment of intraday transfers. The Proposed Rule also conservatively requires that outflows be assumed to occur at the earliest possible date, while inflows are assumed to occur on the last possible date.

The Proposed Rule includes specified outflow rates that are intended to approximate severe liquidity stress. They were developed by taking into account supervisory experience and observation from the recent financial crisis.[4] The LCR's proposed outflow categories and corresponding outflow rates include the following (outflow rates for Modified LCR Companies would be 70 percent of the LCR's otherwise applicable outflow rates):

- **Unsecured Retail Funding:** This category generally includes deposits from individuals and small businesses and would range from 3 percent for stable retail deposits that are fully FDIC-insured to 40 percent for uninsured retail brokered sweep deposits.

Generally, retail depositors have been less likely to withdraw their deposits during periods of liquidity stress than other customers, and, therefore, their deposits would be assigned lower outflow rates.

- **Unsecured Wholesale Funding:** This category includes most sources of unsecured funding from customers and counterparties that are not individuals or small businesses. Due to the more volatile nature of this funding, the proposed outflow rates would range from 25 percent for certain operational deposits (where a banking organization provides services that require its customers to maintain certain deposit balances with the banking organization, making the deposit more stable) to 100 percent for commercial paper or nonoperational deposits from financial entities whose securities cannot be included in HQLA. Generally, unsecured, uninsured wholesale corporate deposits not provided by financial sector entities would be assigned a 40 percent outflow rate.
- **Secured, Short-term Funding:** The proposed outflow rates for secured short-term funding would increase progressively, reflecting the liquidity characteristics of the collateral. Secured funding backed by Level 1 liquid assets would be assigned an outflow rate of zero, secured funding backed by Level 2A liquid assets would be assigned a 15 percent outflow rate, and secured funding backed by Level 2B liquid assets would be assigned a 50 percent outflow rate. Secured funding backed by non-HQLA would be assigned a 100 percent outflow rate.
- **Commitments:** The proposal includes a low outflow rate (5 percent) for retail credit facilities because retail customers are less likely than wholesale customers to draw on the facilities in times of liquidity stress. Outflow rates on most corporate credit facilities would not exceed 40 percent, while liquidity facilities to non-bank financial institutions (including asset-backed commercial paper conduits) would receive an outflow rate of 100 percent. Outflow rates on credit or liquidity facilities to banks would be 50 percent. The Proposed Rule clarifies that general working capital facilities (including revolving credit facilities for general corporate or working capital purposes) are not liquidity facilities.
- **Net Derivative Cash:** The Proposed Rule's outflow rate for this category is 100 percent of payments and collateral that the LCR Covered Company must make or provide to counterparties under derivative transactions net of payments and collateral to be received from such counterparties under legally enforceable netting agreements.
- **Federal Reserve Borrowings:** Under the Proposed Rule, Federal Reserve borrowing of any kind generally is treated the same as other secured wholesale borrowings. Borrowings that are due to the Federal Reserve within 30 days are assumed not to be renewed, are included in net outflows, and are assigned an outflow rate that reflects the liquidity characteristics of the collateral, consistent with the outflow rates assigned to secured short-term funding, as described above. Furthermore, within local implementing discretion permitted under the Basel LCR, the capacity to borrow from the Federal Reserve is not included in HQLA.

Under the Proposed Rule, total cash inflows are to be calculated as the lesser of (i) the sum of cash inflow amounts and (ii) 75 percent of expected cash outflows.

Cash inflow amounts include the following:

- **Net Derivatives Cash:** The sum of payments and collateral to be received from each counterparty to a derivatives transaction net of payments and collateral to be made or provided to such counterparty under a legally enforceable netting agreement.
- **Retail Contractual Payments:** An amount equal to 50 percent of the sum of all

contractual payments to be received from retail customers and counterparties.

- **Unsecured Wholesale Payments:** An amount equal to the sum of (i) 100 percent of payments from regulated financial companies, nonregulated funds, pension funds, investment advisers and identified companies and from central banks, plus (ii) 50 percent of payments from other wholesale customers.
- **Payments on Non-HQLA Securities:** An amount equal to 100 percent of payments on securities owned by the LCR Covered Company and not included in its HQLA amount.
- **Secured Lending Transactions:** Inflows from any lending transaction requiring a counterparty to pay the LCR Covered Company that is secured under applicable law by a lien on HQLA assets with inflow rates determined by the type of collateral.

The Proposed Rule, however, specifically excludes from qualifying cash inflows (i) amounts held as operational deposits at other regulated financial companies, (ii) amounts from forward sales of mortgage loans and related commitments, (iii) amounts from any credit or liquidty facility extended to an LCR Covered Company, (iv) amounts for any HQLA included in the LCR Covered Company's HQLA amount. (v) amounts payable to the LCR Covered Company under a nonperforming asset or an asset that will become nonperforming within the specified stress period, and (vi) any payments on an item that has no contractual maturity or that will not mature within the specified stress period.

Because of the myriad liquidity stresses that an LCR Covered Company may experience, the proposal would give supervisors flexibility in responding to instances in which a company's LCR falls below the minimum LCR requirement. In addition, the Proposed Rule would require an LCR Covered Company to submit a plan to its primary federal regulator on how it would achieve compliance with the proposed LCR requirements if its LCR remains below 100 percent for three consecutive business days, or longer, or if the supervisor otherwise determines the company to be materially noncompliant with the LCR requirement.

For more information about the topics raised in this Legal Update, please consult your regular Mayer Brown contact or either of the following lawyers.

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Endnotes

[1] The Proposed Rule would not permit HQLA to include securities issued by regulated financial companies. For this purpose, "regulated financial companies" are defined to include banking organizations, broker-dealers, insurance companies, and other companies subject to prudential regulation, as well as their consolidated subsidiaries, and, in the case of a depository institution holding company, companies included in the top-tier holding company's organizational hierarchy on the National Information Center website; mutual funds, investment advisers, hedge funds, private equity funds, pension funds, and any company the FRB determines should be treated the same as the foregoing companies based on similar activities.

[2] This generally would include all OECD sovereign debt unless the debt was in default or restructured consistent with the revised capital rule (*see* 78 *Federal Register* 62018 (October 11, 2013).

[3] GSEs include the Federal Home Loan Mortgage Corporation, the Federal National Mortgage Association, the Farm Credit System, and the Federal Home Loan Banks (FHLBs). Capacity to borrow from the FHLBs is not included in HQLA.

[4] On October 23, 2013, the Basel Committee issued a related working paper that includes some case studies intended to inform the understanding of the key drivers of liquidity stresses. These case studies provided support for some, but not all of the Proposed Rule's outflow treatments.

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