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FEDERAL REGULATORS PROPOSE NEW RULE MANDATING STRICTER LIQUIDITY REQUIREMENTS THAN INTERNATIONAL STANDARDS

The Board of Governors of the Federal Reserve System (FRB), Office of the Comptroller of the Currency (OCC), and Federal Deposit Insurance Corporation (FDIC) (collectively, the agencies) have jointly proposed a new rule[1] to implement the liquidity standards agreed to by the Basel Committee on Banking Supervision (Basel Committee) earlier this year.[2] However, the Proposed Rule goes beyond the Basel Committee's Liquidity Coverage Ratio (LCR) in several key respects. Most notably, the Proposed Rule:

- Narrows the types of assets that qualify as High Quality Liquid Assets (HQLA);
- Uses a more conservative measure of total net cash outflows over the 30-day stress period;
- Applies a modified LCR to bank holding companies (BHCs) and savings and loan holding companies (SLHCs) that are not internationally active, but that have at least $50 billion in total assets; and
- Imposes an accelerated timeline that requires covered companies to fully comply with the LCR by 2017, two years ahead of the Basel III LCR transition timeline.

Together, these changes will require institutions subject to the Proposed Rule to hold more liquid assets more quickly.

SUMMARY OF THE LIQUIDITY COVERAGE RATIO

The Basel Committee established, for the first time, global minimum liquidity standards for internationally active banking organizations. The Proposed Rule implements these standards in the U.S. for:

- Banking organizations with $250 billion or more in total assets or $10 billion or more in on-balance sheet foreign exposure, and to their consolidated subsidiary depository institutions with $10 billion or more in assets;
- Depository institutions with $250 billion or more in total assets or $10 billion or more in on-balance sheet foreign exposure; and

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[1] Liquidity Coverage Ratio: Liquidity Risk Measurement, Standards, and Monitoring (Oct. 24, 2013) (draft) [hereinafter "Proposed Rule"], *available at* http://www.federalreserve.gov/FR_notice_lcr_20131024.pdf.

[2] Basel Committee on Banking Supervision, *Basel III: The Liquidity Coverage Ratio and Liquidity Risk Monitoring Tools* (January 2013) [hereinafter "Basel III LCR"], *available at* http://www.bis.org/publ/bcbs238.pdf.

- Nonbank systemically important financial institutions (SIFIs) designated by the Financial Stability Oversight Council that do not have significant insurance operations.

The entities covered by the Proposed Rule are collectively known as the "covered companies." Finally, the Proposed Rule applies a modified LCR to BHCs and SLHCs with at least $50 billion in total assets that do not have substantial insurance activities, even if such companies are not internationally active.[3]

Both the Basel III LCR and the Proposed Rule require a covered company to maintain an amount of unencumbered HQLA (the numerator of the ratio) that covers at least 100 percent of the company's net cash outflows over a short-term stress period (the denominator of the ratio).[4] However, the Proposed Rule measures both the numerator and denominator more conservatively than the Basel III LCR.

THE NUMERATOR—DEFINITION OF HIGH QUALITY LIQUID ASSET

HQLA are assets that should be easily and immediately convertible into cash with little or no loss of value during a period of stress.[5] Both the Basel III LCR and the Proposed Rule distinguish among three categories of liquid assets: Level 1, Level 2A, and Level 2B. Level 1 assets are the highest quality, most liquid assets, and they may be included in a covered company's HQLA without limit. Level 2A and 2B assets are very liquid, but not to the same degree as Level 1 assets. Accordingly, the total amount of Level 2A and 2B assets may not exceed 40 percent of total HQLA, and Level 2B assets alone may not exceed 15 percent of total HQLA. Additionally, to reflect the varying quality of these assets, Level 2A assets count towards the LCR at only 85 percent of their value (a 15 percent "haircut"), and Level 2B assets are subject to a 50 percent haircut.

The Basel III LCR and the Proposed Rule differ in several important ways with respect to these categories of HQLA:

- **Corporate Debt Securities**: The Basel III LCR provides that certain high-quality corporate debt securities and covered bonds with a long-term credit rating of at least AA– qualify as Level 2A liquid assets, subject to a 15 percent haircut.[6] In addition, certain corporate debt securities with a long-term credit rating of at least BBB– qualify as Level 2B assets, subject to a 50 percent haircut.[7] Under the Proposed Rule, by contrast, investment grade corporate debt securities qualify only as Level 2B liquid assets, subject to a 50 percent haircut, and never qualify as Level 2A assets.[8] These differences stem in part from section 939(d) of the Dodd-Frank Act, which prohibits the agencies from using external credit ratings in regulations.

- **Common Equity**: The Basel III LCR counts certain common equity shares listed in a major stock index as a Level 2B liquid asset, subject to a 50 percent haircut.[9] The Proposed Rule

[3] Proposed Rule at 11–12.

[4] *See* Basel III LCR at ¶ 17; Proposed Rule at 92 (proposed 12 C.F.R. § __.10).

[5] *See id.* at 15; Basel III LCR at ¶ 24. Both the Basel III LCR and the Proposed Rule define HQLA as liquid assets that exhibit low risk and limited price volatility, are traded in high-volume, deep markets with transparent pricing, and are ideally eligible to be pledged at a central bank. The assets may not be encumbered or issued by a covered financial institution, and they may not fall within any of a number of excluded categories.

[6] *See* Basel III LCR at ¶ 52(b).

[7] *Id.* at ¶54(b).

[8] *See* Proposed Rule at 94 (proposed § __.20(c)(1)).

[9] *See* Basel III LCR at ¶ 54(c).

implements these requirements for common equity held by covered companies, but only so long as the equity is not held by a depository institution. Because of general statutory prohibitions or limitations on depository institutions holding equity investments for their own account (such as limitations on how long a depository institution may hold common stock acquired to satisfy debt previously contracted), depository institutions subject to the Proposed Rule will not be permitted to include common equity in their Level 2B liquid assets.[10]

- **Public Sector Entities**: The Basel III LCR includes in Level 2A assets certain covered bonds with a long-term credit rating of at least AA–, subject to a 15 percent haircut.[11] In addition, the Basel III LCR allows claims on public sector entities (PSEs), such as a state or other subdivision below the national level, to be included in Level 1 and Level 2A assets.[12] In contrast, the Proposed rule "likely would not permit covered bonds and securities" issued by PSEs to qualify as HQLA because the agencies believe that "these assets are not liquid and readily-marketable in U.S. markets."[13]

- **Mortgage-backed Securities**: The Basel III LCR permits certain residential mortgage-backed securities with a long-term credit rating of at least AA to qualify as Level 2B liquid assets, subject to a 25 percent haircut.[14] The Proposed Rule does not include these assets at all.

THE DENOMINATOR—CALCULATION OF TOTAL NET CASH OUTFLOWS DURING STRESS PERIOD

Under both the Basel III LCR and the Proposed Rule, the denominator of the LCR is the amount of a covered company's expected cash outflows less expected inflows over a 30-day stress period—the total net cash outflow. However, the Proposed Rule is more conservative with respect to the calculation of the total net cash outflow:

- **Maturity Mismatch**: The Basel III LCR measures the total net cash outflow over the entire 30-day period.[15] In contrast, the Proposed Rule measures the total net cash outflow amount using the *highest* net cash outflow day within the 30-day stress period.[16] Thus, a covered company must calculate its total stressed net cash outflow for each of the 30 calendar days, then use the largest net cash outflow day as the denominator of the LCR.[17] This conservative treatment reflects the agencies' belief that using the largest difference between cumulative inflows and outflows is necessary to account for potential maturity mismatches between a covered company's outflows and inflows.[18]

- **"Stable" Retail Deposits**: The Basel III LCR estimates an outflow rate of 3 to 5 percent for "stable deposits" that are fully covered by government deposit insurance.[19] These deposits are subject to a low estimated outflow rate because customers generally do not withdraw fully insured

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[10] *See* Proposed Rule at 26–27, 95 (proposed § __.20(c)(2)(v), (vi)).

[11] *See* Basel III LCR at ¶ 52(b).

[12] *Id.* at ¶¶ 50(c), 52(a).

[13] Proposed Rule at 24.

[14] *See* Basel III LCR at ¶ 54(a).

[15] *See id.* at ¶ 69.

[16] Proposed Rule at 38, 100 (proposed 12 C.F.R. § __.30).

[17] *Id.* at 38–39.

[18] *Id.*

[19] *See* Basel III LCR at ¶¶ 75–78.

deposits in times of stress due to their confidence in the government's guarantee.[20] Unlike the Basel III LCR, however, the Proposed Rule only recognizes FDIC deposit insurance, and not foreign deposit insurance, because of variability among foreign deposit insurance systems.[21]

- Mortgage Inflows: The Proposed Rule expressly excludes from inflows any amount a covered company may receive from forward sales of mortgage loans and any derivatives that are mortgage commitments.[22] The agencies believe that "inflow amounts from [mortgage] transactions may not materialize during a liquidity crisis or may be delayed beyond the 30-day time horizon."[23]

MODIFIED LCR FOR SMALL, NON-INTERNATIONALLY ACTIVE BANKS

The Basel III LCR only applies to internationally active banks.[24] Although the Proposed Rule primarily targets such banks, it also applies a modified LCR to smaller banking organizations with at least $50 billion in assets that do not have substantial insurance activities.[25] For these smaller banking organizations, the Proposed Rule calculates the stress scenario based on a 21-day period rather than a 30-day period, and the total net cash outflow is calculated over this entire 21-day period rather than on the highest net cash outflow day.[26] The Proposed Rule also estimates lower outflow rates for these companies subject to the modified LCR. For example, "stable" retail deposits are subject to a 2.1 percent outflow rate rather than a 3 percent outflow rate.[27] These less stringent requirements reflect the agencies' belief that "these companies would likely not have as great a systemic impact as larger, more complex companies if they experienced liquidity stress."[28]

TRANSITION TIMELINE

The Basel III LCR requires internationally active banking organizations to meet 60 percent of the LCR requirement by 2015, and increases the requirement by an additional 10 percent each year to reach full compliance by 2019.[29] The Proposed Rule substantially accelerates this phase-in period to require covered companies to meet 80 percent of the LCR requirement by 2015, 90 percent by 2016, and 100 percent by 2017.[30] The agencies reason that this accelerated timeline is

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[20] *See id.* at ¶ 75; Proposed Rule at 45–46.

[21] Proposed Rule at 45 & n. 48, 46–47.

[22] *Id.* at 108 (proposed 12 C.F.R. § __.33(a)(2)).

[23] *Id.* at 63.

[24] Basel III LCR at ¶¶ 6 & 164. Although Basel does not expressly define the term "internationally active," the agencies have interpreted it to mean banking organizations with at least $250 billion in total consolidated assets or at least $10 billion in on-balance sheet foreign exposure.

[25] Section 165 of the Dodd-Frank Act requires the agencies to establish enhanced prudential standards, including liquidity requirements, for SIFIs and BHCs with at least $50 billion in assets. *See* 12 U.S.C. § 5365(a) & (b). It also grants the agencies authority to tailor these enhanced standards according to these institutions' size, capital structure, riskiness, complexity, financial activities, and other risk-factors. *See id.* § 5365(a)(2). Pursuant to that authority, the agencies have proposed a modified LCR that would apply to these smaller banking institutions to reflect the fact that they are generally less complex in structure and less reliant on riskier forms of market funding.

[26] *See* Proposed Rule at 71.

[27] *See id.* at 72–73 (Table 3).

[28] *Id.* at 70.

[29] Basel III LCR at ¶ 10

[30] Proposed Rule at 69.

appropriate "to build on the strong liquidity positions these companies have achieved since the recent financial crisis, thereby providing greater stability to the firms and the financial system."[31]

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[31] *Id.*