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US Banking Regulators Implement the Basel III Liquidity Coverage Ratio

On September 3, 2014, the Federal Reserve Board, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation (the "**Agencies**") adopted a final rule (the "**Final Rule**") implementing a quantitative minimum liquidity coverage ratio ("**LCR**") requirement for the largest, internationally active US banking organizations.[1] The Final Rule is generally consistent with the LCR standard established by the Basel Committee on Banking Supervision (the "**Basel Committee**"),[2] although it differs in some respects from the standard adopted by the Basel Committee. Under the Final Rule, "covered companies" (as defined below) generally will be required to maintain a minimum amount of unencumbered high-quality liquid assets ("**HQLAs**") that is equal or exceeds estimated net cash outflows over a 30-day standardized supervisory liquidity stress scenario.

The Agencies anticipate that the LCR requirement, which is to be fully phased-in on January 1, 2017, will strengthen the resilience of covered companies and the broader US financial system. The impact of the LCR is difficult to predict, however, particularly considering the cumulative impact of a host of new rules related to capital, liquidity, leverage, and other prudential standards. In that regard, it should be noted that the Final Rule is intended to complement the FRB's regime of enhanced prudential supervision under Section 165 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Dodd-Frank Act**"), which, among other things, requires company-run liquidity stress testing and contingency planning. The Final Rule will also be complemented by a separate rulemaking establishing a Net Stable Funding Ratio ("**NSFR**"), which the Agencies anticipate implementing following the adoption of a final international version of the NSFR by the Basel Committee. Interestingly, the Federal Reserve Board staff has estimated that most covered companies would currently meet the LCR requirement if it was fully phased-in today, and that the shortfall in HQLAs for firms that currently do not meet the LCR requirement is approximately $100 billion out of an aggregate of approximately $2,500 billion ($2.5 trillion) in HQLAs.

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[1] On the same day, the Agencies also adopted a final rule modifying the definition of the denominator of the supplementary leverage ratio in a manner consistent with recent changes agreed to by the Basel Committee on Banking Supervision to better capture certain off-balance sheet exposures, including credit derivatives, repo-style transactions, and lines of credit. The revisions to the supplementary leverage ratio apply to all US banking organizations subject to the advanced approaches risk-based capital rule.

[2] Basel Committee, "Basel III: The Liquidity Coverage Ratio and liquidity risk monitoring tools" (January 2013), available at http://www.bis.org/publ/bcbs238.htm (the "**Basel III Revised Liquidity Framework**").

Notwithstanding the perceived systemic benefits of the LCR, it will be associated with significant costs. Covered companies will have to deal with these costs and with the operational burdens of yet another regulation the application of which is far from straightforward. Covered companies will need to devote significant resources and dedicated personnel to perform *on a daily basis* the exceedingly complex LCR calculation, including the analysis of data and legal documentation that the calculation will require. The increased compliance costs and the LCR standard itself will further reduce the operating margins of covered companies. And the Final Rule will almost certainly drive up the demand for some assets (*e.g.*, US Treasury bonds), while reducing the demand for others (*e.g.*, municipal securities),[3] which will likely result in market and asset price distortions.

Scope of Application

Companies covered for purposes of the Final Rule are: (i) US-domiciled top-tier bank holding companies and savings and loan holding companies, with certain limited exclusions ("**covered depository institution holding companies**") that have $250 billion or more in total consolidated assets or $10 billion or more in on-balance sheet foreign exposure;[4] and (ii) consolidated subsidiary depository institutions of covered depository institution holding companies with $10 billion or more in consolidated assets (collectively, "**covered companies**"). A modified less stringent version of the LCR requirement applies to covered depository institution holding companies with total consolidated assets of $50 billion or more that are not covered companies ("**modified LCR holding companies**").

The Agencies' LCR proposal in November 2013 would have generally applied to nonbank financial companies designated as systemically important by the Financial Stability Oversight Council. However, the Final Rule does not apply to designated nonbank financial companies. The Federal Reserve Board has indicated that it may, instead, establish separate LCR requirements for such companies by order or rule.

In addition, the Final Rule does not apply to foreign banking organizations or to US intermediate holding companies required to be formed under the Federal Reserve Board's Regulation YY (implementing the enhanced prudential requirements of Section 165 of the Dodd-Frank Act) that are not otherwise covered companies. The Federal Reserve Board has stated that it anticipates implementing an LCR-based standard through a future separate rulemaking for the US operations of some or all foreign banking organizations with $50 billion or more in combined US assets.

Effective Date

The Final Rule is effective as of January 1, 2015, but the rule includes a transitional phase-in period for the full application of the LCR requirement. Covered companies will be subject to a minimum LCR of 80% as of the effective date of January 1, 2015. From January 1, 2016, through December 31, 2016, the minimum LCR will be 90%. From and after January 1, 2017, all covered companies will be required to maintain an LCR of 100%.[5]

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[3] The Federal Reserve Board staff is expected to issue for public comment at a later date a proposal to include certain highly liquid municipal securities as HQLAs.

[4] These thresholds have been used generally by the Agencies for purposes of applying internationally agreed capital adequacy standards developed by the Basel Committee.

[5] These transitional periods are shorter than the transitional periods provided in the Basel III Revised Liquidity Framework, which delays the full phase-in of the LCR requirement until January 1, 2019.

Covered companies will also have a transitional period to comply with the requirement for daily calculation of the LCR. Depository institution holding companies with $700 billion or more in total consolidated assets or $10,000 billion ($10 trillion) or more in assets under custody, and any depository institution that is a consolidated subsidiary of such depository institution holding companies that has total consolidated assets equal to $10 billion or more, are required to calculate their LCR on the last business day of the calendar month from January 1, 2015, to June 30, 2015, and beginning on July 1, 2015, must calculate their LCR on each business day. All other covered companies are required to calculate the LCR on the last business day of the calendar month from January 1, 2015, to June 30, 2016, and beginning on July 1, 2016, must calculate their LCR each business day.

Modified LCR holding companies will not be subject to the rule until January 1, 2016, and will be required to calculate their LCR monthly, rather than daily. Modified LCR holding companies will be subject to an LCR requirement of 90% during 2016, and 100% during 2017 and thereafter calculated on the last business day of each month.

LCR Calculation

The LCR equals HQLAs as of the calculation date divided by a total net cash outflow amount calculated as prescribed by the Final Rule. The LCR for covered banking organizations must be equal to or greater than 1.0 on each business day. Modified LCR holding companies will be required to maintain an LCR equal to or greater than 1.0 on the last business day of each calendar month.

HQLAs

Consistent with the Basel III Revised Liquidity Framework, the Final Rule establishes three categories of HQLAs: (i) level 1 liquid assets; (ii) level 2A liquid assets; and (iii) level 2B liquid assets.

- ***Level 1 liquid assets*** generally include –
  1. reserve bank balances in excess of the minimum Regulation D reserve requirements;
  2. withdrawable reserves held with non-US central banks;
  3. securities issued by or unconditionally guaranteed as to principal and interest by the US Treasury;
  4. "liquid and readily marketable"[6] securities issued by or unconditionally guaranteed as to principal and interest by certain other US government agencies; and
  5. liquid and readily marketable securities unconditionally guaranteed as to principal and interest by non-US sovereigns and certain multinational organizations that (A) are assigned a 0% risk weight under the US Basel III standardized approach capital rules or (B) in the case of securities issued or guaranteed by non-US sovereigns, are issued in the sovereign's own currency and held by the covered banking organization to meet net cash outflows in that jurisdiction.

  Level 1 liquid assets are not subject to supervisory haircuts.

[6] Liquid and readily-marketable security is a security traded in an active secondary market with (1) more than two committed market makers; (2) a large number of non-market maker participants on both the buy and sell sides; (3) timely and observable market prices; and (4) a high trading volume.

- ***Level 2A liquid assets*** generally include liquid and readily marketable securities that –
  i. are issued or guaranteed by a US government sponsored enterprise and qualify as investment grade under regulations applicable to national banks;
  ii. are issued or guaranteed by a non-US sovereign or a multilateral development bank and assigned a 20% risk weight under the US Basel III standardized approach capital rules; or
  iii. are issued or guaranteed by a non-financial sector entity whose obligations have a proven record as a reliable source of liquidity during stressed market conditions (on the basis of a maximum 10% adverse change test).

  Level 2A liquid assets are subject to a 15% haircut and, when combined with level 2B liquid assets, they cannot exceed 40% of the total HQLA amount.

- ***Level 2B liquid assets*** generally include –
  i. liquid and readily marketable corporate debt securities that qualify as investment grade under regulations applicable to national banks and are issued or guaranteed by a non-financial sector entity whose obligations have a proven record as a reliable source of liquidity during stressed market conditions (on the basis of a maximum 20% adverse change test); and
  ii. liquid and readily marketable publicly traded equity securities that are included in specified stock indexes (including the Russell 1000 Index) and are issued by a non-financial sector entity whose publicly traded common shares have a proven record as a reliable source of liquidity during stressed market conditions (on the basis of a maximum 40% adverse change test).

  Level 2B liquid assets, are subject to a 50% haircut and cannot exceed 15% of the total HQLA amount.

Operational Requirements for HQLAs

Each HQLA must meet a host of criteria and operational requirements to be eligible as a HQLA. Among other things, HQLAs must be unencumbered and readily convertible to cash during periods of stress. The covered banking organization must (i) demonstrate an operational capability to monetize the HQLAs; (ii) implement policies requiring eligible HQLAs to be under the control of the liquidity risk management function; (iii) implement policies and procedures designed to determine that composition of HQLAs on each calculation date; and (iv) establish a documented methodology for ensuring that HQLAs meet the eligibility operational requirements and criteria set forth in the rule. The fair value of HQLAs must be reduced by the outflow amount that would result from the termination of any specific transaction hedging eligible HQLAs. Also, eligible HQLAs held by US or foreign consolidated subsidiaries are subject to certain adjustments.

Calculation of the Net Cash Outflow Amount

Under the Final Rule, a total amount of net cash outflows is calculated by subtracting cash inflows from cash outflows over a period of 30 calendar days with adjustments to reflect certain standardized supervisory stress assumptions and to address maturity mismatches. Cash inflows that offset cash outflows will be capped at 75% of total outflows. The Final Rule assigns standardized supervisory inflow and outflow rates to various types of inflows and outflows (by types of assets, liabilities, and off-balance sheet exposures).

The prescribed cash inflow and outflow rates are intended to capture liquidity stress scenarios resulting in (i) a partial loss of unsecured wholesale funding capacity; (ii) a partial loss of secured, short-term financing with certain collateral and counterparties; (iii) losses from derivative positions and the collateral supporting those positions; (iv) unscheduled draws on committed credit and liquidity facilities that a covered company has provided to its customers; (v) the potential need for a covered company to buy back debt or to honor non-contractual obligations in order to mitigate reputational and other risks; (vi) a partial loss of retail deposits and brokered deposits from retail customers; and (vii) other shocks that affect outflows linked to structured financing transactions, mortgages, central bank borrowings, and customer short positions. Lower outflow rates are assigned to sources of funding associated with lower liquidity risk (*e.g.*, "stable retail deposits" are assigned an outflow rate of 3%), while higher liquidity risk funding sources are assigned higher outflow rates (*e.g.*, excess collateral that a counterparty can contractually demand to be returned is assigned an outflow rate of 100%).

The total net cash outflow amount is equal to the sum of cash outflow amounts over the calculation period of 30 calendar days adjusted by the applicable specified cash outflow rate, *minus* the sum of cash inflow amounts for the calculation period adjusted by the applicable specified cash inflow rate and capped at 75% of the total cash outflows, *plus* a maturity mismatch add-on. The maturity mismatch add-on calculation is designed to ensure that the total net cash outflow amount reflects a covered banking organization's highest liquidity need during the 30-day period.

The maturity mismatch add-on calculation requires a covered company to identify the largest single-day maturity mismatch within the 30-day period by calculating the daily difference in cumulative outflows and inflows that have set maturity dates. The day with the largest difference reflects the net cumulative peak day. The maturity mismatch add-on is then calculated as the difference between that peak day amount and the net cumulative outflow amount on the last day of the 30-day period for those same outflow and inflow categories that have maturity dates within the 30-day period. The Agencies have acknowledged that the maturity mismatch add-on calculation approach involves complexity not contemplated by the Basel III Revised Liquidity Framework and could potentially require some covered companies to hold more HQLAs than required by the Basel Committee standard, but have nonetheless determined to adopt this approach in light of the perceived material liquidity risks posed by maturity mismatches.

Net cash outflows for modified LCR holding companies will be reduced by a factor of 70%. Also, modified LCR holding companies will not be required to identify maturity mismatches within the 30-day stress period.

Supervisory Monitoring and Enforcement

The Basel III Revised Liquidity Framework establishes liquidity risk monitoring mechanisms, including with respect to collection of information on contractual maturity mismatch, concentration of funding, available unencumbered assets, LCR reporting by significant currency, and market-related monitoring tools. The Final Rule does not implement these monitoring mechanisms, but the Agencies have indicated that they intend to obtain information from covered companies to enable the monitoring of liquidity risk exposure through reporting forms and information the agencies collect through other supervisory processes.[7]

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7 The Agencies have also indicated that they anticipate seeking comment on regulatory reporting requirements pertaining to the LCR in a separate rulemaking notice.

The Agencies have also stated that they recognize that, under certain circumstances, it may be necessary for a covered company's LCR to fall briefly below 100% to fund unanticipated liquidity needs. The Final Rule establishes, however, a framework for a flexible supervisory response when a covered company's LCR falls below 100%. The Agencies have stated that depending on the circumstances, an LCR shortfall would not necessarily result in a supervisory action, but, at a minimum, would result in heightened supervisory monitoring.

Under the Final Rule, a covered company must notify its primary federal banking regulator on any business day that its LCR is less than the minimum requirement. If a covered company's LCR is below 100% on any LCR calculation date, the covered company must consult with its primary federal banking regulator to determine whether it should provide a "Liquidity Plan" for achieving compliance with the minimum requirement. Further, if a covered company's LCR is below 100% for three consecutive business days, or if its primary federal banking regulator has determined that the covered company is otherwise materially noncompliant with the LCR requirement, the covered company must promptly submit a Liquidity Plan for remediation of the shortfall.

The Final Rule provides that a covered company's primary federal banking regulator may, at its discretion, take supervisory or enforcement actions to address noncompliance with the minimum LCR requirement. A potential supervisory or enforcement action would depend on the nature of operational issues identified at the covered company, whether the violation is a part of a pattern or practice, whether the liquidity shortfall was temporary or caused by an unusual event, and the extent of the shortfall or noncompliance.

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