Financial Services Management

Systemic Liquidity Standards

Cite
FRB
Final Rule
Liquidity Requirements for Bank Holding Companies

Recommended Distribution
CFO, Treasury, Asset/Liability Management, Risk Management, Policy, Legal, Government Relations

Website

http://www.federalreserve.gov/newsevents/press/bcreg/20140218a.htm

Impact Assessment

- The combination of new U.S. liquidity standards with pending leverage rules poses a major strategic challenge for big BHCs, especially G-SIBs and similar FBOs.
- New liquidity buffers make U.S. standards higher than global liquidity requirements, equivalent to the *de facto* higher capital charges in the U.S. resulting from stress testing. This may make large U.S. BHCs more resilient, but it also create competitiveness challenges in affected areas (e.g., securities financing, repos, securitization). Challenges vis-a-vis non-banks in key business lines will grow more acute as there is no comparable non-bank liquidity regime.
- Pricing in asset classes treated as highly-liquid – especially U.S. Government, agency, and GSE obligations – could be distorted due to higher demand for these assets, reducing interest rates in a manner adversely affecting net interest margin and subsidizes certain activities (e.g., mortgage finance). Concentration risk in favored asset classes could also spike, creating interest-rate, duration, and other risks banks address through hedging strategies adversely affected by an array of new rules. Efforts to control liquidity risk could thus inadvertently create new systemic risks not now subject to express prudential regulation.

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- Yield-chasing could become a more significant prudential concern because large banks may seek to offset the cost of holding large amounts of high-quality assets by cherry-picking eligible ones with unusual yield or other profit-generating characteristics. The FRB believes it will prevent this through supervision and other controls.
- Big-bank use of FHLB advances could increase since pledged collateral will not be treated as encumbered.
- Senior management will need to take a far more hands-on role regarding liquidity risk management, requiring new reporting lines, other changes in Treasury operations at many BHCs. Board responsibilities are significant, but far less than initially proposed and largely consistent with the new risk-tolerance standards governing BHC boards.

Overview

The FRB has finalized new liquidity requirements for U.S. BHCs with assets over $50 billion, setting qualitative requirements in an area also soon to be subject to major quantitative requirements through the inter-agency proposal to set a liquidity-coverage ratio (LCR)[1] and a new global net stable funding ratio (NSFR).[2] The new standards go well beyond the U.S. and global ones in many respects, especially with regard to the need for stress testing, contingency funding and buffers. As a result, they will require significant changes in liquidity-risk management at covered BHCs and foreign banks, as well as complicate compliance with looming leverage requirements. Overall market changes and new drivers for "shadow banks" could result if these rules combine with others governing banks to create a shortage of high-quality assets available for regulatory purposes.

Impact

This rule finalizes a controversial 2012 proposal[3] that imposes tougher U.S. requirements than planned under either the LCR or NSFR. As a result, the approach poses challenges to covered U.S. BHCs, as well as to the foreign banking organizations (FBOs) brought under it by the tough new rules for them finalized in tandem with the liquidity requirements.[4] Commenters strongly protested many aspects of the proposal, but the Board reiterated in finalizing it that the Dodd-Frank Act mandates systemic-liquidity standards[5] and that experience during the crisis warrants an approach that does not violate national treatment for FBOs because it applies across the spectrum for

[1] See **LIQUIDITY13**, *Financial Services Management*, November 5, 2013.
[2] See **LIQUIDITY14**, *Financial Services Management*, February 4, 2014.
[3] See **SYSTEMIC54**, *Financial Services Management*, January 3, 2012.
[4] See **FBO3**, *Financial Services Management*, February 25, 2014.
[5] See **SYSTEMIC29**, *Financial Services Management*, July 13, 2010.

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comparable banking organizations in the U.S. and is based on existing Basel standards[6] and inter-agency guidance.[7]

Many industry commenters argued that the proposal was formulaic and did not reflect the low liquidity risk at smaller BHCs. However, the FRB counters in the final rule that its approach is the minimum needed for BHCs above $50 billion, with the largest institutions expected to meet still more stringent standards often spelled out in the rule. As a result, despite the tough new buffers and other standards, the largest BHCs now face a formidable new liquidity-risk management framework that may complicate capital planning, new-product development and other strategic considerations.

Indeed, the capital impact of this rule could be formidable for covered BHCs and FBOs. U.S. BHCs come under stringent capital rules toughened in the Dodd-Frank Act[8] and shortly to be hiked still higher with a supplementary leverage ratio for the very largest U.S. BHCs.[9] FBOs will come under the U.S. leverage standards in 2018, with U.S. operations of FBOs that meet the criteria for the higher leverage charge likely also to come under it over time. These leverage requirements impose capital charges of as high as six percent on assets treated as risk-free under the risk-based capital standards. These assets include cash, certain sovereign obligations, agency issuances, and other assets treated as high-quality ones for purposes not only of the overall liquidity rules, but also these tougher systemic standards. Thus, the more assets BHCs must hold to meet liquidity requirements, the higher their leverage capital requirements, possibly reducing credit availability and certainly reducing profitability perhaps in tandem with lowered risk.

To protect both basic business lines and profitability, covered BHCs may well drop exposures scored as high-risk liquidity ones under the rules, perhaps reducing financial-system resilience because funding lines to other financial institutions will be curtailed. BHCs will be forced to hold more high-quality assets not just for these liquidity rules, but also for new margin requirements and other standards designed to correct for risk positions that exacerbated the financial crisis. Global regulators have noted that this hike in demand for low-risk assets could pose risks of its own,[10] driving key activities – e.g., securities financing – to "shadow" institutions and impeding the ability of central banks quickly to craft new monetary-policy responses to future shocks. They and commenters on this rule also argued that limiting eligible asset categories, especially given how stringent the U.S. rules are, may exacerbate concentrations in sovereign obligations, a concern the FRB sought to allay not only by liberalizing the treatment of otherwise-eligible assets used in hedging GSE exposures (e.g., FHLB collateral), but also by

[6] See **LIQUIDITY2**, *Financial Services Management*, June 27, 2008.

[7] See **LIQUIDITY6**, *Financial Services Management*, March 24, 2010.

[8] See **FHC19**, *Financial Services Management*, July 29, 2010.

[9] See **LEVERAGE**, *Financial Services Management*, July 16, 2013.

[10] See **SYSTEMIC69**, *Financial Services Management*, October 4, 2013.

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indicating a tough stand on potential concentration risk resulting from the new rule. However, U.S. sovereign and agency exposures are exempt from diversification requirements, perhaps exacerbating concentration concern related to them.

That these new FRB standards will force larger holdings of high-quality assets seems certain. The FRB did not alter key parameters in its proposal, finalizing stringent requirements related to cash-flow projections, contingency funding, and the setting of liquidity-risk limits. Importantly, the rule also requires covered BHCs and FBOs to hold liquidity buffers above minimum quantitative requirements, establishing these under stringent stress-test standards. Buffers could drop under stress, but firms will be expected to plan for this and quickly to recover through, for example, regular "monetization" exercises to ensure that assets held to comply with this rule are indeed as liquid as calculated. All of these standards create a high *de facto* liquidity requirement as appears intended by the FRB. In theory, these rules apply to systemic non-banks once designated by the FSOC; in practice, significant changes to them will likely be required just as the FRB has learned as it tried to impose capital standards on depository institution holding companies that are principally insurance entities.

One of the biggest changes from the proposal is the role the board is to play in managing liquidity and ensuring compliance with these qualitative standards. The proposal would have required the board or its risk committee to determine matters such as cash-flow projections and to validate an array of internal assumptions in a way commenters argued effectively made directors risk managers. Accepting this, the final rule differentiates the role of directors into the more usual one of setting risk tolerances and ensuring that they are adhered to and changed as circumstances warrant. Senior management is, however, to take on significant new responsibilities. The chief risk officer required by other provisions in these systemic rules is charged with an array of liquidity-risk decisions, and independent review is also mandated to ensure that risk tolerances and validation are done independently of Treasury or similar units making day-to-day funding decisions.

What's Next

The FRB unanimously approved this rule at its February 18 meeting.[11] Covered institutions must comply with it as of January 1, 2015, although it is likely that in practice firms will be given a transition period due to the stringent nature of many new standards and the infrastructure needed to comply with them.

The NPR included a request for comment on a short-term debt limit in addition to the systemic liquidity standards. The final rule does not include one, although it indicates that this remains under consideration. Gov. Tarullo

[11] See Client Report **FBO2**, February 18, 2014.

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has been particularly outspoken about the need for such a limit and it may well be proposed later this year for G-SIBs and, perhaps, certain FBOs.

Analysis

A. Governance

1. Board of Directors

The final rule requires the board of directors to approve the company's liquidity risk tolerance at least annually, to receive and review information from senior management at least semi-annually to determine whether the BHC is operating in accordance with its established liquidity risk tolerance, and to approve and periodically review the liquidity risk management strategies, policies, and procedures established by senior management. Unlike the proposal, it assigns responsibility for reviewing and approving the contingency-funding plan to the risk committee.

2. Risk Committee

This committee or the board must review the contingency-funding plan, doing so at least annually and when any action might affect the plan.

3. Senior Management

Senior management such as the CRO -- rather than the risk committee as initially proposed -- is to review and approve new products and business lines and evaluate liquidity costs, benefits, and risks related to each new business line and product that could have a significant effect on the liquidity risk profile and to annually review the liquidity risk of each significant business line and product. Senior management is also to establish and implement liquidity risk management strategies, policies, and procedures and to oversee the development and implementation of liquidity risk measurement, monitoring and reporting systems, cash-flow projections, liquidity stress testing and associated buffers, specific limits, and the contingency-funding plan. Senior management must report as needed, but no less than on a quarterly basis. It must also at least quarterly review compliance with the liquidity limits and cash-flow projects, ensuring that they are set in conformance with the standards described below. The liquidity stress-test parameters must also be approved by senior management, conducting more frequent reviews if conditions warrant.

4. Independent Review

This is required at least annually by units that do not execute funding decisions in a process detailed in the final rule. Where permissible, this independent reviewer is to report material risk-management issues to the board or its risk committee.

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B. Liquidity Risk Measurement

1. Cash-flow Projections

Comprehensive projections are required on long- and short-term -flow (respectively updated monthly and daily) related to assets, liabilities, and off-balance sheet exposures (OBEs). Minimum projections must cover:

- contractual maturities;
- intra-company transactions;
- new business;
- renewals;
- customer options;
- other germane events;
- cumulative cash-flow mis-matches over identified time periods; and
- future asset, liability, and OBE behavior due to the BHC's capital, structure, risk profile, currency exposures, complexity, size, and activities.

These analyses should be done by business line, currency, and legal entity as appropriate. These analyses may also demonstrate the need for more frequent cash-flow projections than otherwise required under the minimum standards included in the rule, with more frequent analyses required of all firms during stress conditions. Projections longer than one year may also be needed due to these analyses although the rule does not require them. Extensive documentation is also required.

2. Contingency-Funding Plan

These are to ensure that BHCs can handle funding crises and are able to identify early-warning signals of emerging stress events (e.g., negative publicity on an asset class held by the bank, widening debt or CDS spreads, and OBE funding). The final rule continues to require the proposed advance planning, but drops aspects that commenters considered overly-mechanical even though the plan must still be regularly reviewed to ensure it is consistent with changing circumstances. Testing of the plan continues to require simulations that include war-room rebalancing, but actual re-booking is not required. Lines of credit, including those from FHLBs, may be included in the contingency-funding plan as long as the BHC ensures that collateral and other conditions for accessing it (e.g., higher margins) are also assessed in the plan. Discount-window funding may also be counted as long as, again, eligibility criteria are stress-tested and, in this case, scenarios for replacing it with more permanent funding sources are also modelled. The final rule also continues to require that BHCs identify in advance the circumstances that would deploy a contingency-funding plan, including failure to meet any minimum FRB liquidity requirement.

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3. Liquidity-Risk Limits

BHCs are to identify limits on potential sources of liquidity risk, including:

- specified sources of liquidity risk, such as concentrations of funding by instrument type, single counterparty, counterparty type, secured and unsecured funding, and other liquidity risk identifiers;
- the amount of liabilities that mature within various time horizons; and
- OBEs and other exposures that could create funding needs during liquidity-stress events.

These limits are to be set consistent with facts such as size, complexity, and asset/liability mix.

4. Collateral, Legal Entity, and Intraday Liquidity Risk Monitoring

BHCs are to maintain sufficient liquidity in light of possible obstacles to cash movements between specific legal entities or separately-regulated entities in normal times and during liquidity-stress events, including with regard to intraday risk.

C. Liquidity Buffers

1. Stress Testing

This must include factors such as reputational risk and set buffers above minimum requirements to ensure adequate liquidity under the quantitative portions of the contingency-funding plan. Tests are to be conducted at least monthly. These tests are to include at least three stress scenarios accounting for adverse market conditions, idiosyncratic stress events, and combined market and idiosyncratic events – with these scenarios other than the idiosyncratic ones also required to anticipate simultaneous stress across the market. Time periods for the tests must include:

- Overnight;
- Thirty days;
- Ninety days;
- One year; and
- Any other relevant time horizon.

The stress scenario should meet diversification requirements that now exempt concentrations in U.S. Government obligations, U.S. agencies, and GSEs.

The CRO is to approve the factors in the stress test which are also subject to independent review.

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2. *Buffers*

In addition to holding buffers across all of the time periods noted above as determined by the stress tests, covered BHCs must hold sufficient unencumbered highly-liquid assets over the range of stress scenarios in the thirty-day period. Eligible assets include:

- cash;
- obligations of the U.S. Government or its agencies and GSEs; and
- any other asset the firm demonstrates meets defined liquidity characteristics regardless of whether the asset is permitted in the LCR. The rule details what the BHC would need to show the FRB to be allowed to count any such asset in its buffer, stating that sovereign obligations and highly-rated corporates might be acceptable if specified conditions are met.

Diversification requirements are designed to prevent undue concentrations in eligible asset classes. Haircuts also apply to these assets as set by the BHC in consultation with the FRB and firms will need periodically to monetize assets treated as unencumbered ones just to be sure they can be used as liquidity under stress.

3. *Buffer Use*

The final rule clarifies that firms can use their buffers under demonstrated stress conditions, although it also mandates that they rebuild them immediately thereafter. However, a supervisory or enforcement action could result if a buffer is reduced substantially or falls below its stressed liquidity needs as identified by the stress test because of operational issues or inadequate liquidity risk management, as determined by the FRB.

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