U.S. Liquidity Coverage Ratio

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Final Rule
Liquidity Coverage Ratio: Liquidity Risk Measurement Standards

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Impact Assessment

- The LCR is an immediate liquidity floor for U.S. G-SIBs, but most banking organizations with assets over $250 billion will not only need to ensure they meet its demands, but also to prepare to meet new rules for longer-term liquidity and additional risks related to short-term funding. Importantly and in contrast to the NPR, liquidity may fall below the LCR under certain stress conditions, permitting the LCR to serve as a buffer under stress.
- The final rules apply not only at the parent holding company level, but also to subsidiary insured depositories with assets above $10 billion. HQLAs sufficient to meet U.S. needs must be held in the U.S. As a result, liquidity is effectively ring-fenced. This strengthens each entity, but at the cost of flexibility and, perhaps, resilience across the organization.
- HQLAs will need to be maintained or increased, creating significant new risks due to growing shortages, transfer of some activities to "shadow" entities, and rising interest rates. Costs associated with HQLAs are significant in the U.S. due to the leverage rule, with these costs having particular strategic impact for U.S. G-SIBs.
- Foreign banks doing business in the U.S. are exempted from the LCR, but should prepare for examiner inquiry and future rules at least as stringent as those applicable to U.S. banks.
- U.S. designated SIFIs and other entities regulated by the FRB with significant insurance operations are also exempted, but again should

prepare for a new liquidity regime considerably different than that imposed on them under insurance regulation. Designated SIFIs without significant insurance activities come under these rules as to DIHCs and SLHCs with large broker-dealer and other non-insurance, non-commercial activities. Major strategic change is thus likely.

- Assets not counted or not given full credit within the definition of HQLA for LCR purposes which banks now hold for added liquidity (not return *per se*) will experience changes in market demand, with this of particular concern to Home Loan Banks. Municipal issuers also fear adverse impact, but coverage for them remains under consideration.
- Securitization will be more costly, since the rules assume that inflows from asset sales will be sharply curtailed under stress and that banks will also need fully to support any private-label securitizations they issue regardless of a contractual commitment to do so.

Overview

The U.S. rules are considerably more stringent than the global liquidity standard,[1] and come into effect for the biggest banks not only more quickly than the global standards, but also in concert with tougher capital rules. As a result, the standards will have significant business and policy impact (e.g., funding ring-fencing within multi-bank/cross-border firms) even though regulators believe the largest U.S. institutions are generally already in compliance with them. Regional banks for which the LCR is more challenging are given some latitude to facilitate compliance, but many will likely still find it problematic due to their current reliance on holdings not given the credit commenters argued they deserved. Importantly, the final rule permits covered institutions to fall below the 100 percent ratio, making it a buffer; however, significant restrictions are imposed to ensure that exceptions are rare and very quickly corrected. Decisions about which assets do or do not count for positive consideration will have significant effect on these asset classes, with municipal-bond issuers and GSEs most concerned about the adverse impact of the new standards for marketing their obligations and those derived from them.

Impact

As laid out in the initial U.S. proposal[2], the LCR requires a company subject to the rule to maintain high-quality liquid assets or HQLAs (the numerator of the ratio) no less than 100 percent of its total net cash outflows over a prospective thirty calendar-day period (the denominator of the ratio). The minimum LCR is 100% as determined in the rule based on an array of

[1] See **LIQUIDITY13**, *Financial Services Management*, November 5, 2013.

[2] See Client Report **LIQUIDITY16**, September 3, 2014.

assumptions first about what is an HQLA and then on how funding inflows and cash outflows will behave under stress conditions. This basic structure follows the Basel III agreement on the LCR, although as noted the U.S. has decided not only to mandate compliance with the rule more quickly for the biggest banks than Basel, but also to tighten the rule in several significant respects. The FRB has also finalized systemic liquidity risk-management standards applied to all BHCs with assets over $50 billion and systemically-important financial institutions (SIFIs) designated as such by the FSOC,[3] although the treatment of insurance companies has been postponed pending broader determination by the FRB of the appropriate regulatory framework for any company with large insurance operations that falls under its purview.

As discussed below, HQLAs are tightly defined. To meet this rule and many others that also require HQLA holdings (e.g., new margin requirements), banks may need significantly to increase their HQLA holdings. This not only has the asset-class and earnings issues discussed below, but also may create a shortage of high-quality assets across the financial system. Global regulators have raised concerns about this,[4] as well as recently assessing the risk that collateral management and transformation may increase.[5] However, nothing is proposed to alleviate these shortages and it is far from clear that collateral services will do so without government intervention. If these shortages occur, then hedge funds and other non-banks will gain greater market clout in the near term even as the ability of central banks to conduct monetary policy may well be undermined and markets may become increasingly subject to liquidity freezes – a potentially perverse result of this new liquidity regime.

One of the most significant concerns expressed when the LCR was first finalized in 2010 was how it will work in concert with the tougher capital rules finalized by Basel at the same time.[6] Of most concern was the interplay between the requirement to hold larger amounts of HQLAs even as new leverage standards imposed higher capital requirements on HQLAs that many believe are well above the actual risk (often zero in the risk-based weightings) for these same obligations. With the U.S. now having adopted the enhanced supplementary leverage ratio for the very largest U.S. banks,[7] the capital burden of meeting the LCR has become particularly acute for G-SIBs. Even though U.S. G-SIBs generally meet HQLA requirements for the LCR, the capital cost of the rule is only now being incorporated into that of the

[3] See **LIQUIDITY15**, *Financial Services Management*, February 27, 2014.

[4] See **SYSTEMIC67**, *Financial Services Management*, May 31, 2013.

[5] See **SYSTEMIC73**, *Financial Services Management*, September 25, 2014.

[6] See **CAPITAL173**, *Financial Services Management*, January 7, 2011.

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

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new leverage requirement to determine strategic consequences. For many G-SIBs, this will lead to very significantly increased costs that may either cause them sharply to adjust their funding positions – the regulatory objective – or to alter broader asset holdings to add risk and compensate for the heightened cost of meeting the LCR.

The definition of eligible HQLAs is among the most contentious in the final rule. Municipal obligations, even general-obligations from large issuers, do not count in any of the "levels" of eligible HQLAs. Municipal issuers and regional banks strongly protested this and the FRB has thus promised to study the question further and, if it determines that some municipal obligations are sufficiently liquid, propose this for comment. The FDIC and OCC are less supportive of including these obligations, with the issue thus facing considerable hurdles even if the FRB study supports commenter assertions. However, in a concession to municipalities and regional banks, the final rule includes a more generous treatment of secured municipal deposits, eliminating a barrier to continuing to accept them.

As noted, securitization will lose much regulatory benefit for liquidity purposes despite the value originators derive from it as they exchange assets for investor funds. This may cause covered banks to focus still more intently on portfolio lending, as well as to make the greatest possible use of government-backed channels to the secondary market (where new liquidity standards related to contingent commitments and reputational risk do not apply). The final HQLA definition also includes the proposed limits on counting obligations of the GSEs and advances from the Federal Home Loan Banks. This was done in conformance with the global rules despite the significant difference in U.S. finance created by the large role played by these GSEs.

The LCR will apply at both the parent and subsidiary insured-depository level for covered firms. Commenters objected to this in part on grounds that the Dodd-Frank Act[8] requires BHCs to be a source of support for subsidiary insured depositories, further questioning this ring-fenced approach on grounds that it reduces resilience across a firm because excess liquidity in one entity could not be transferred under stress to another unless the transferring company could sustain above-minimum levels. The agencies decided on the consolidated approach on grounds that risks are different across companies – i.e., insured depositories have access to the Federal Reserve and are backed by the FDIC, thus warranting specific liquidity standards regardless of other entities within a corporate group. The final rule is, however, posited on liquidity within each entity without regard to federal support.

[8] See **FHC19,** *Financial Services Management*, July 20, 2010.

What's Next

This rule was finalized by the FRB, OCC, and FDIC on September 3.[9] Consistent with the Basel III Revised Liquidity Framework, the final rule is effective as of January 1, 2015, subject to the transition periods. Covered companies are thus required to maintain a minimum LCR of 80 percent beginning January 1, 2015. From January 1, 2016, through December 31, 2016, the minimum LCR is 90 percent. Beginning on January 1, 2017, covered banks are required to maintain an LCR of 100 percent. Modified-LCR firms are required to calculate a monthly LCR starting in January, 2016. The final rule delays implementation of the daily-calculation requirement, although G-SIBs must begin to do so in July, 2015, calculating monthly LCRs beginning in January of next year. Other firms may calculate the LCR monthly until July, 2016.

As noted, non-bank depository institution holding companies (DIHCs) are exempt from this rule, but will be subjected to something like it by the FRB by rule or order. The final rule does not lay out a time period for doing so. A rule would ensure a comparable LCR across all covered DIHCs, but take longer and perhaps not address the unique nature of many of them; orders on a firm-by-firm basis would do so, although at the potential cost of more rapid implementation and differences with competitive impact. The agencies decided not to exempt savings & loan holding companies (SLHCs) with large broker-dealer operations from the rule because they believe these pose liquidity risk not captured by SEC regulation.

Foreign banking organizations (FBOs) and their intermediate holding companies (IIHCs) are also exempt. This may reflect not only the more challenging task of identifying liquidity risk in institutions with large, offshore parent organizations, but also the many restrictions already imposed on FBOs and IHCs by the FRB in its new rule governing them.[10] The Board in that rule retained considerable supervisory discretion that is likely to push FBOs and IHCs quickly to liquidity standards akin to the LCR, with carve-outs afforded as institutions persuade the FRB to permit them. However, the FRB plans to propose an LCR for some or all FBOs with assets over $50 billion at a future date.

The final U.S. rule does not include Basel's monitoring and reporting requirements. Regulatory-reporting requirements will be separately proposed.

9 See Client Report **LIQUIDITY16**, February 4, 2014.

10 See **FBO3**, *Financial Services Management*, February 25, 2014.

Analysis

A. Scope

1. Coverage

The rule covers bank holding companies, certain SLHCs, and depository institutions with $250 billion or more in total assets or $10 billion or more in on- balance sheet foreign exposure and their consolidated subsidiaries that are depository institutions with $10 billion or more in total consolidated assets. A modified LCR was simultaneously adopted by the FRB for BHCs and SLHCs without significant insurance or commercial operations that are not internationally active.

2. Exemptions

Non-bank depository-institution holding companies and their subsidiary depository institutions are exempted, with the FRB planning instead to impose an LCR on them by rule or order on a firm or category basis. FBOs are as noted also exempt unless otherwise covered.

B. Ratio Buffers

As noted, the final rule permits firms to fall below the 100 percent ratio for unanticipated liquidity needs. If this occurs, the firm must notify its appropriate federal regulator on any business day this occurs. If the LCR stays below 100 percent for three or more consecutive business days, then a remediation plan must also be provided. Provisions are also made for times when there is a monthly LCR calculation either by large firms as they transition to daily calculation or for those under the modified approach.

C. Minimum Requirements

Nevertheless, the LCR should be viewed as a minimum requirement. G-SIBs or other banks that pose systemic risk or those with liquidity stress-test deficiencies will be held to a higher standard. As noted, BHCs with assets over $50 billion are subject also to qualitative liquidity-stress standards that the agencies believe complement these quantitative ones.

D. HQLAs

1. General Requirement

HQLAs must be unencumbered by liens and other restrictions on transfer and must convert quickly into cash without reasonable expectation of losses in excess of the applicable LCR haircuts during a stress period. Banks must demonstrate that they can monetize these assets without loss under stress by, among other things, periodically liquidating holdings to ensure ready monetization. Ordinary operations in the course of business that monetize assets do not count for these purposes.

HQLAs must be segregated to the extent necessary to ensure ready access to them by the Treasury liquidity-management function, with segregated customer funds held by broker-dealers specifically ineligible as HQLAs (although certain provisions related to inflow calculations were made in the final rule). As noted above, HQLAs for each market's inflows and outflows must generally be housed in that nation. Thus, U.S. banks may not count on HQLAs held in foreign affiliates or branches for purposes of the LCR.

2. *Levels*

These are:

- Level 1 HQLAs, with no limits or haircuts. These HQLAs include U.S. and full-faith-and-credit agency obligations, certain multilateral-organization obligations, certain other sovereign debt; and certain Federal Reserve balances. The agencies are considering the merits of including central bank restricted committed facility capacity as HQLA and may propose this for comment;
- Level 2A, with a fifteen percent haircut. These assets are GSE obligations and FHLB advances and other obligations issued by multilateral development banks and sovereigns; and
- Level 2B, with a fifty percent haircut. These assets include high-quality corporate bonds (which must not be obligations of non-GSE financial firms but need not be traded on an exchange as proposed), with certain publicly-traded equities (but not ETFs comprised of them) also eligible. Consistent with the proposal, municipal bonds do not count, nor do assets allowed in the global rules such as private-label securitizations.

Level 2A and Level 2B assets together may not be more than forty percent of total HQLAs, with 2B assets further limited to no more than fifteen percent. Although these levels include the assets noted above, even these may not be included if the institution or its regulator does not believe they meet the general liquidity and encumbrance criteria noted above. In general, all of these HQLAs should be the types of assets to which markets turn during "flights to quality." As a result, it is at best questionable if structured instruments (e.g., CMOs) based on HQLAs would be considered as HQLAs. Security-by-security analysis is necessary to ensure HQLA eligibility.

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E. Inflows and Outflows

The agencies' calculations here are critical to the LCR but very detailed. Key points include:

- These calculations are based on standardized stress scenarios also detailed in the rule that take into account the recent financial crisis and thus are severe. These scenarios are intended to capture both idiosyncratic and market-wide stress.
- Inflows are limited to 75 percent of outflows to provide a further level of safety. Maturities and their matching within the thirty-day period is to be done in compliance with standards detailed in the final rule. Maturity is also to be calculated as specified.
- Inflows and outflows are to be calculated on peak days within the thirty-day LCR period. As noted, this requirement differs from the Basel standard and is more stringent. However, the final rule includes an "add-on" approach that somewhat limits the impact of this requirement.
- Operational deposits are given more favorable treatment in the inflow calculation. Outflow rates for SPVs are revised better to reflect the risk posed by SPVs that rely on market funding.
- Retail-funding outflows are generally unchanged from the NPR, although there is a slightly more generous treatment of certain brokered deposits.
- Structured transactions of all sorts, including private-label MBS, continue to have a 100 percent outflow rate, based in part on expectations by the agencies that reputational risk will force banks to support these investments. Net derivatives outflows also have a 100 percent rate, with a major change made to reflect netted FX transactions reflecting full exchanges to reduce outflow rates for these transactions.
- Securitization transactions and mortgage commitments continue to be covered by strict calculations, based on the agencies' view that anticipated inflows will not materialize under stress even though banks will be called upon to honor any commitments related to them.
- Credit and liquidity facilities now include any for these purposes, including letters of credit and all liquidity backstops other than those for retail-mortgage commitments (treated stringently elsewhere). Outflow commitments to REITs remain at a 100% outflow rate and ABCP facilities are to be treated as liquidity facilities regardless of their possible use also for credit risk. There is no special treatment for investment companies CCPs, or other financial-market utilities in the final rule. Inflows from facilities provided by other financial institutions are assumed to be zero, while outflows to them in facilities committed by the bank are assumed to be 100%. Banks must also ensure adequate liquidity for derivatives-valuation changes, building needed operational capacity to do so as detailed in the final rule.
- Broker-dealer sweeps of funds into the bank, especially those from unaffiliated brokers, are given the proposed conservative inflow and outflow assumptions.