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Regulatory Practice Letter

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Basel III Liquidity Coverage Ratio – Proposal of U.S. Bank Regulators

Executive Summary

The Federal Reserve Board (Federal Reserve), the Office of the Comptroller of the Currency (OCC), and the Federal Deposit Insurance Corporation (FDIC) (collectively, the Agencies) have jointly released a proposed rule that would implement in the United States (U.S.) a quantitative liquidity requirement for large, internationally active banking organizations, which generally includes, bank holding companies (BHCs), certain savings and loan holding companies (SLHCs), and depository institutions with more than $250 billion in total assets or more than $10 billion in on-balance sheet foreign exposure, and their consolidated depository institution subsidiaries with $10 billion or more in total consolidated assets. The rule would also apply to companies that do not have significant insurance operations but have been designated as systemically important by the Financial Stability Oversight Council and required to be supervised by the Federal Reserve as well as to those companies' consolidated depository institution subsidiaries that have $10 billion or more in total consolidated assets (collectively with the large banking organizations, covered companies).

As proposed, the U.S. quantitative liquidity requirement (US LCR) requires a covered company's stock of "unencumbered high-quality liquid assets" (HQLAs) to equal at least 100 percent of its "total net cash outflows" over a 30-day standardized supervisory liquidity stress scenario. The ratio is intended to be generally consistent with the liquidity coverage ratio standard established by the Basel Committee on Banking Supervision (Basel Committee) as a component of the Basel III capital framework (Basel III LCR). However, the proposed US LCR is more stringent than the Basel III LCR in several respects, including the range of assets that qualify as HQLA, the assumed rate of outflows of certain kinds of funding, and the shorter transition period to full implementation. Comments will be accepted through January 31, 2014.

The Federal Reserve is concurrently proposing to impose a modified quantitative liquidity requirement (modified LCR) on BHCs and SLHCs without significant insurance or commercial operations that have $50 billion or more in total consolidated assets and are not otherwise covered companies. The modified liquidity requirement would employ a 21-day stress period.

The US LCR and modified LCR would become part of the Federal Reserve's comprehensive liquidity risk oversight program for large banking organizations that, in addition to the quantitative liquidity measures, would include enhanced liquidity risk management standards such as internal liquidity stress testing under the Section 165 enhanced prudential standards required by the *Dodd-Frank Wall Street Reform and Consumer Protection Act* (Dodd-Frank Act)..

Background

In March 2010, the Agencies, along with the National Credit Union Administration and the Conference of State Bank Supervisors issued guidance titled the "*Interagency Policy Statement on Funding and Liquidity Risk Management*," specifying supervisory expectations for fundamental liquidity risk management practices. The guidance incorporates elements of the Basel Committee's 2008 "*Principles for Sound Liquidity Management and Supervision*" and "emphasizes the central role of corporate governance, cash-flow projections, stress testing, ample liquidity resources, and formal contingency funding plans as necessary tools for effectively measuring and managing liquidity risk."

In December 2011, the Federal Reserve released a proposed rule that would create a new Regulation YY, *Enhanced Prudential Standards*, to implement portions of Sections 165 and 166 of the *Dodd-Frank Wall Street Reform and Consumer Protection Act* (the "Dodd-Frank Act") for U.S. BHCs with total consolidated assets of $50 billion or more and nonbank financial companies deemed systemically important by the Council. The Section 165 requirements would include: risk-based capital and leverage; liquidity; single-counterparty credit limits; overall risk management; risk committees; and stress tests. (Please refer to KPMG Regulatory Practice Letter 12-04.) As proposed, the enhanced liquidity standards would address corporate governance provisions, senior management responsibilities, independent review, a requirement to hold highly liquid assets to cover stressed liquidity needs based on internally developed stress models, a contingency funding plan, and specific limits on potential sources of liquidity risk.

The Basel Committee first published its Basel III LCR requirement in December 2010 as part of the Basel III capital reforms. A revised Basel III LCR standard was published in January 2013, including amendments to the definition of HQLA and net cash outflows, an extension of the timetable for the phase-in of the standard, and clarifications to the text regarding the Basel Committee's intention for the stock of liquid assets to be used in times of stress. Once fully implemented, the 100 percent threshold of the Basel III LCR is to serve as a minimum requirement in normal times. During a period of stress, banks would be expected to use their pool of liquid assets, thereby temporarily falling below the minimum requirement.

The Basel III LCR requirement will be introduced on January 1, 2015 at 60 percent of the minimum requirement. The applicable percentage will rise in equal annual steps of 10 percentage points to reach 100 percent on January 1, 2019. The phase-in arrangement is intended to align with the Basel III capital adequacy requirements.

The Agencies acknowledge in the US LCR proposal that an international study of the interaction between the Basel III LCR and central bank operations is ongoing. They state they will consider amending the US LCR proposal if the Basel Committee proposes modifications to the Basel III LCR.

Description

US LCR

The proposed US LCR would require a covered company to maintain a ratio of unencumbered HQLAs (the numerator of the ratio) to total net cash outflows (the denominator of the ratio) that is no less than 100 percent over a prospective 30-calendar day period (the 30-day stress period). The proposed rule also defines which instruments would constitute HQLAs, prescribes standardized cash inflow and outflow rates that a covered company would be required to use to calculate its total net cash outflows over the 30 day stress period (i.e. the stress scenario); and, prescribes the methodology that would be used for calculating total net cash outflows, including capping cash inflows at 75 percent of cash outflows. Items would not be permitted to be double counted in the computation (included in the numerator and the denominator).

A covered company would be required to calculate the US LCR at the same time on every business day (referred to as the calculation date). A covered company is to choose the calculation time prior to the effective date of the proposed rule and to notify its primary Federal banking regulator. A change in the daily calculation time would not be permitted without written approval from the regulator.

Implementation

The proposed rule provides for a transition period that begins January 1, 2015 and would require covered companies to comply with a minimum US LCR of 80 percent as of that date. Between January 1, 2016, and December 31, 2016, the minimum US LCR would be 90 percent; Beginning January 1, 2017 and thereafter, all covered companies would be required to maintain a minimum US LCR of 100 percent.

HQLA (the US LCR numerator)

The Agencies state that the qualifying criteria for HQLAs, as outlined in the proposed rule, "are designed to identify assets that exhibit low risk and limited price volatility, are traded in high-volume, deep markets with transparent pricing, and that are eligible to be pledged at a central bank." They should be easily and immediately convertible into cash with little or no loss of value during a period of liquidity stress.

The Agencies are proposing to divide HQLAs into three categories of assets: Level 1; Level 2A; and Level 2B.

- Level 1 Assets – would be the highest quality, most liquid assets and would be includable without haircuts or any limit. Level 1 Assets would include:
  - Federal Reserve Bank balances;
  - Withdrawable foreign central bank reserves;
  - Securities issued or unconditionally guaranteed by the U.S. Department of the Treasury;
  - Liquid and readily-marketable securities issued or unconditionally guaranteed by any U.S. government agency, provided that the obligations are fully and explicitly guaranteed by the full faith and credit of the United States government;
  - Certain liquid and readily marketable securities that are claims on, or claims guaranteed by, a sovereign entity, a central bank, or other international entities that are assigned a zero percent risk-weight under the US Basel III

standardized approach capital rules and the issuing entity has a proven record as a reliable source of liquidity in the repurchase or sales markets during stressed market conditions
    - Certain liquid and readily marketable debt securities issued by sovereign entities in their own currency.

- Level 2 Assets - would be subject to prescribed haircuts and, in total would not be permitted to exceed 40 percent of a covered company's total HQLAs.
    - Level 2A Assets – would be subject to a 15 percent haircut from fair value (measured under US Generally Accepted Accounting Principles (GAAP)). They would include certain liquid and readily-marketable claims on, or claims guaranteed by, a U.S. government sponsored enterprise (GSE), and certain claims on, or claims guaranteed by, a sovereign entity or a multilateral development bank and assigned a 20 percent risk-weight under the US Basel III standardized approach to the capital rules.
    - Level 2B Assets – would be subject to a 50 percent haircut from fair value (measured under GAAP), and also limited to 15 percent of HQLAs. Level 2B Assets would include certain liquid and readily marketable publicly traded corporate debt and equity securities issued by non-financial companies.

A covered company would be required to meet certain "operational requirements" with regard to the assets in its HQLAs, including:

- Having the capability to monetize the HQLAs
- Implementing policies that require all HQLAs to be under the control of the management function that is charged with managing liquidity risk (e.g., segregating the assets)
- Adding the amount of cash outflow that would result from the termination of any specific transaction hedging HQLAs in the total net cash outflow amount
- Implementing and maintaining policies and procedures that determine the composition of the HQLAs on a daily basis, including by legal entity, geographical location, currency, and qualification, among other things
- Establishing policies to ensure that HQLAs maintained in foreign locations are appropriate with respect to where the net cash outflows arise.

HQLAs held by a U.S. consolidated subsidiary of a covered company would be included in HQLA subject to specific limitations depending on whether the subsidiary is subject to the proposed rule and is therefore required to calculate a US LCR under the proposed rule. For a non-U.S. consolidated subsidiary, the proposal would require covered companies to identify the location of HQLAs and net cash outflows and exclude any HQLA above net cash outflows that is not freely available for transfer due to statutory, regulatory, contractual or supervisory restrictions. The Agencies add that while "it is appropriate for a covered company to hold HQLA in a particular geographic location in order to meet liquidity needs there, they do not believe it is appropriate for a covered company to hold a disproportionate amount of HQLA in locations outside the United States given that unforeseen impediments may prevent timely repatriation of liquidity during a crisis."

Calculation of HQLA

As of each calculation date, the HQLA would equal:

- Level 1 Assets, *plus*
- Level 2A Assets (adjusted for the 15 percent haircut), *plus*

- Level 2B Assets (adjusted for the 50 percent haircut),
- *Minus* the greater of:
  - The unadjusted excess HQLA asset amount – which would be equal to the sum of the Level 2 cap excess amount and the Level 2B cap excess amount on the first day of the 30-day stress period, without unwinding any transactions, and
  - The adjusted excess HQLA asset amount – which would be equal to the sum of the Level 2 cap excess amount and the Level 2B cap excess amount at the end of the 30-day stress period after unwinding all secured funding transactions, secured lending transactions, asset exchanges, and collateralized derivatives transactions, each as defined by the proposed rule, that mature within a 30-day stress period where HQLA is exchanged.

Total Net Cash Outflows (the denominator of the LCR)

The proposed rule would require a covered company to calculate its total stressed net cash outflow amount for each of the 30 calendar days following the calculation date using the rates provided in the proposed rule (the rates are intended to approximate a severe liquidity stress). For the US LCR calculation, a covered company would use as the denominator the dollar amount on the day within that 30-day stress period that has the largest difference between cumulative inflows and cumulative outflows.

The calculation of the Net Cash Outflows would equal:

- Outflows:
  - The sum of cash outflow amounts (calculated in accordance with the proposed rule), *plus*
  - The sum of cash outflow amounts for instruments or transactions with no contractual maturity (calculated in accordance with the proposed rule), *plus*
  - The sum of cash outflow amounts for instruments or transactions with a contractual maturity up to and including that calendar day (calculated in accordance with the proposed rule),
- *Minus* the lesser of:
  - The sum of the cash inflow amounts (calculated consistent with the proposed rule) and
  - 75 percent of the calculated Outflows

In calculating its cash outflows and inflows, a covered company must make the most conservative assumptions for determining the maturity or transaction date for an instrument or transaction. In general, this would mean assuming:

- The earliest possible date for cash outflows; and
- The latest possible date for cash inflows.

Inflows would include items such as: net derivatives cash, retail contractual payments, unsecured wholesale payments, payments on non-HQLA securities, and secured lending transactions.

Outflows would include items such as: unsecured retail funding, unsecured wholesale funding, secured short-term funding, commitments, net derivative cash, Federal Reserve borrowings.

Shortfall

Covered companies would be expected to maintain a US LCR at or above 100 percent at all times. However, the proposed rule would establish a framework for "flexible supervisory response" when a covered company's US LCR falls below 100 percent. As proposed, a covered company would be required to notify its primary Federal supervisor on any business day that its US LCR is less than 100 percent. And, if the US LCR is below 100 percent for three consecutive business days, a covered company would be required to submit to its primary Federal supervisor a plan for remediation of the shortfall. Similarly, a covered company would be required to submit a remediation plan whenever its primary Federal supervisor determines it is "materially noncompliant" with the provisions of the rule. Such a plan would be required to include:

- An assessment of the covered company's liquidity position
- The actions taken by the covered company and the actions to be taken to achieve compliance with the US LCR requirement including adjustments to risk profile, risk management, and funding sources among other things
- An estimated timeframe to achieve compliance
- A commitment to submit progress reports no less than weekly.

Applicability

The companies covered by the US LCR include:

- Banking organizations with $250 billion or more in total assets or $10 billion or more in on-balance sheet foreign exposure, and their consolidated subsidiary depository institutions with $10 billion or more in total consolidated assets, measured as of the most recent year-end.
- Nonbank financial companies without significant insurance operations designated by the Council as systemically important and subject to supervision by the Federal Reserve, and their consolidated subsidiary depository institutions with $10 billion or more in total consolidated assets.
- Companies not meeting the asset thresholds but for which the Agencies determine application of the US LCR would be appropriate in light of the company's asset size, level of complexity, risk profile, scope of operations, affiliation with foreign or domestic covered companies, or risk to the financial system.

The proposed US LCR would not apply to:

- Opt-in banks for Basel III
- Bridge financial companies or their subsidiaries
- New depository institutions or new bridge financial companies
- SLHCs that:
  - Are grandfathered unitary savings and loan holding companies
  - Derive 50 percent or more of their total consolidated assets or total enterprise-wide revenues from activities that are not financial in nature (measured as of June 30 of the previous year)
- Depository institution holding companies that are insurance underwriting companies

The proposed rule has not addressed how the proposed US LCR would interact with the December 2012 proposed rule to implement enhanced prudential standards for Foreign Banking Organizations.

Stress testing

The proposed rule's liquidity coverage ratio is based on a standardized supervisory stress scenario. While the liquidity coverage ratio would establish one scenario for stress testing, supervisors expect companies that would be subject to the proposed rule to also maintain "robust stress testing frameworks" that incorporate additional scenarios more tailored to the risks within their firms. Covered companies are encouraged to use these additional scenarios in conjunction with the proposed US LCR computation to appropriately determine their liquidity buffers. The Agencies note that the liquidity coverage ratio is a minimum requirement and organizations that pose more systemic risk to the U.S. banking system or whose liquidity stress testing indicates a need for higher liquidity buffers may need to take additional steps beyond meeting the minimum ratio in order to meet supervisory expectations.

Modified LCR

The Federal Reserve is also proposing to apply a modified LCR to BHCs and SLHCs that do not have significant insurance or commercial operations that have $50 billion or more in total consolidated assets and are not otherwise covered by the US LCR requirement (covered institutions). The modified LCR would require these covered institutions to meet the same LCR where HQLAs equal or exceed 100 percent of total net cash outflows over the stress period, subject to the following adjustments:

- The stress period would be 21 days rather than 30 days
- HQLAs would be calculated over a 21 day period with the same definitions and eligibility criteria
- Cash inflow and outflow amounts would be calculated with a contractual maturity date that is within the 21 day period
- Cash inflow and outflow amounts for instruments or transactions with no contractual maturity would be calculated by applying 70 percent of the amount calculated under the US LCR
- The total net cash outflows amount used in the denominator would be the difference between the inflows and outflows at the end of the 21-calendar day liquidity stress period (a peak maximum cumulative outflow day would not be required to be calculated).

Commentary

The Agencies' proposed rule is more stringent than the Basel LCR in a number of respects including:

- Covered companies would be required to comply on an accelerated schedule that results in full implementation by January 1, 2017. In contrast, a 100 percent ratio would be required under the Basel Committee's proposal by January 1, 2019. Interestingly, a 100 percent ratio would be required under the EU CRD IV by January 1, 2018.
- Covered companies would be subject to a different set of requirements based on their total consolidated assets (modified LCR would be applied to BHCs and SLHCs with assets between $50 billion and $250 billion). As a consequence, US large banks and banks with international operations would be less competitive in

the markets, and US smaller banks, subject to modified LCR, would have fewer incentives to growth/consolidation.

- Covered companies with international operations would be subject to multiple versions of the LCR.
- Depository institution subsidiaries with total assets of $10 billion or more would be required to meet the US LCR separately from their covered company parent.
- The definition of qualifying HQLAs is more stringent; it does not include securities issued or guaranteed by public sector entities, covered bonds or residential mortgage backed securities.
- The definition of HQLAs does not include references to external credit ratings. Compared to the Basel Committee's proposal, this would result in higher haircuts for double-A corporate bonds, and would narrow the range of corporate securities that may qualify as HQLA.
- HQLAs are required to equal or exceed total net cash outflows on every day of the 30 day stress period (because they must meet the peak maximum total net cash outflow).
- Different definitions and parameters for cash inflows and outflows with special treatments for specific items (e.g., brokered deposits).

The Agencies indicate that these stricter requirements, especially the accelerated timeframe, are intended to maintain the improved liquidity positions achieved by U.S. institutions since the financial crisis. Nonetheless, covered companies and covered institutions will have to begin preparations to ensure they can meet the final measuring and reporting requirements using the outline in the proposed rule as a guide, as well as to evaluate their funding structures in light of the required US LCR The Agencies are expected to issue a separate proposal addressing regulatory reporting and disclosure requirements for the LCR.

Covered companies must consider that the new liquidity frameworks to be imposed in the U.S. and internationally will drive competition for more stable sources of funding and possibly reduce the availability of wholesale funding, forcing the need for efficient, accurate, and realistic funding plans and strong relationships with funding sources.

Governor Tarullo noted that the release of the US LCR proposal would not be "sufficient to address potential liquidity problems at large banking firms" adding that "this was one of the reasons for the Section 165 measures" (enhanced prudential standards). The US LCR is one component of the Agencies' supervisory framework for liquidity risk management, which, under the enhanced prudential standards rule (when finalized) will require a covered company to meet liquidity buffers under multiple stress testing scenarios in addition to corporate governance and risk management requirements.

Going forward, covered companies and possibly covered institutions will likely have to meet longer-term liquidity measures in the future as the Agencies have indicated they will issue a proposed rule in the U.S. to address a longer-term liquidity requirement once the Basel Committee finalizes its work on the Net Stable Funding Ratio (NSFR). Such a release is anticipated in advance of the Basel Committee's NSFR 2018 implementation.

Governor Tarullo has also stated that it was "important to recognize that the risks associated with short-term wholesale funding are as much or more macroprudential as they are firm-specific, whereas the LCR has a principally microprudential focus, focused as it is on the liquidity of each firm individually." He has suggested that among the Federal Reserve's "highest remaining priorities should be more macroprudentially informed regulatory measures to address the tail risk event of a generalized liquidity stress by forcing some internalization of the systemic costs of this form of financial intermediation." So, it is possible that additional requirements may be forthcoming in this respect as well.

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