CLIENT UPDATE

THE LCR PROPOSAL: QUESTIONS AND ANSWERS

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On October 24, the Federal Reserve, followed on October 30 by the Federal Deposit Insurance Corporation (the "FDIC") and the Office of the Comptroller of the Currency (the "OCC") (collectively, the "Agencies"), released a proposed rule (the "Proposed Rule") that would apply a Liquidity Coverage Ratio (the "LCR") to certain U.S. banking organizations.[1] Currently, U.S. banking regulations do not impose a quantitative liquidity requirement on banking organizations but, instead, require the use of risk management and other tools to manage liquidity needs. The Proposed Rule would for the first time require banking organizations to meet minimum quantitative liquidity standards and, thus, represents an important milestone in the post-crisis regulatory reform process.

The Proposed Rule is broadly consistent with the LCR finalized earlier this year by the Basel Committee on Banking Supervision (the "Basel Committee") but, as with U.S. regulators' implementation of other Basel III initiatives, it is in certain key respects more stringent than the international standard.[2] The proposed LCR would have a shorter phase-in period than the Basel III LCR, and both the numerator and denominator of the LCR would be somewhat more stringent in the Proposed Rule than in the Basel standards.

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[1] Federal Reserve, *Liquidity Coverage Ratio: Liquidity Risk Measurement, Standards, and Monitoring* (Oct. 24, 2013); FDIC, OCC, *Liquidity Coverage Ratio: Liquidity Risk Measurement, Standards, and Monitoring* (Oct. 30, 2013).

[2] Basel Committee, *Basel III: The Liquidity Coverage Ratio and liquidity risk monitoring tools* (revised Jan. 2013), *available at* http://www.bis.org/publ/bcbs238.pdf.

The proposed LCR requirement, in combination with recent regulatory initiatives, such as the reform of the over-the-counter derivatives markets, may increase demand for high-quality collateral, as banking organizations seek to optimize yield on these assets. This increased demand in turn may lead to shortages of key assets in the marketplace. In addition, because high-quality liquid assets tend to generate lower returns, the net effect of these reforms may be to cause banking organizations to rethink business lines that, while profitable, present significant demands to maintain the high-quality, low net margin collateral demanded by the LCR.

The Proposed Rule is open for comment until January 31, 2014. We summarize key aspects of the Proposed Rule in a series of questions and answers below. We also highlight differences between the Basel III LCR and the Proposed Rule **in bold**.

BACKGROUND AND SCOPE

What Would the Proposed Rule Require?

The Proposed Rule would require banking organizations and certain other covered companies, as discussed below, to calculate an LCR on a daily basis. That LCR would be measured by comparing an organization's high-quality liquid assets ("HQLA") against its total net cash outflows.

Put differently, a covered organization would calculate daily the amount of its projected liquidity outflows and inflows for the next 30 (or in the case of some, generally smaller organizations, 21) calendar days. The organization then would need to ensure that its portfolio of HQLA meets or exceeds its highest level of daily net cash outflows expected (for organizations subject to the 30-day LCR), or its total cash outflows expected (for organizations subject to the 21-day LCR), under certain stress scenarios over the calculation period.

Graphically, the LCR requirement would be represented by the following equation:

HQLA
Level 1 up to 100%
Level 2 up to 40%
Level 2A
Level 2B up to 15%

LCR = ———————— ≥ 1

Total Net Cash outflows = Maximum net cumulative daily outflows over the next 30 calendar days

ORGANIZATIONS THAT MUST COMPLY

Which Companies Would Be Subject to the Proposed LCR?

Large Banking and Systemically Important Organizations. Subject to certain important exclusions, which are discussed next, the Proposed Rule would apply a more stringent 30-day LCR to:

- bank holding companies ("BHCs") and savings and loan holding companies ("SLHCs") with $250 billion or more in total consolidated 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; and
- nonbank financial companies designated by the Financial Stability Oversight Council (the "FSOC") and their consolidated subsidiary depository institutions with $10 billion or more in total consolidated assets.

Smaller Banking Organizations. The Proposed Rule would apply a less stringent 21-day LCR to U.S. depository institution holding companies with total consolidated assets of $50 billion or more that do not meet the above-noted thresholds. For these entities, the LCR would apply only at the holding company level and not with respect to their subsidiary depository institutions.

Foreign Banking Organizations. The Proposed Rule does not clarify how the LCR requirement would interact with the separate Federal Reserve proposal that, if adopted, would require certain foreign banking organizations to establish U.S. intermediate holding companies ("IHCs") that would be subject to consolidated prudential, including liquidity, standards by the Board.[3] Thus, it is not clear whether these IHCs, if the Board determines to move forward with that proposal, would eventually be required to meet a U.S. LCR.

How would SLHCs and nonbank financial companies designated by FSOC with significant insurance or commercial operations be treated under the Proposed Rule?

Insurers and Commercial Companies. Insurers are proposed to be excluded by the agencies. Specifically, a company with substantial insurance operations, *i.e.*, a company (i) whose top-tier company is an insurance underwriting company or (ii) that holds 25 percent or more of its total consolidated assets in subsidiaries that are insurance underwriting companies, would be excluded from the LCR requirements. These exclusions are essentially the same as were contained in recent final rules implementing the Basel III capital standards. Unlike those capital rules, however, which appear to contemplate only a temporary exclusion for insurers, there is no indication that insurance companies will be brought into the scope of this rule in a separate proposal at a later time.

SLHCs with significant commercial operations would also be excluded from the Proposed Rule.

HIGH-QUALITY LIQUID ASSETS (NUMERATOR)

What Assets Would Qualify as HQLA?

The Proposed Rule would allow for three levels of HQLA.

- The most liquid and stable assets – such as central bank reserves, debt securities issued or fully guaranteed by the U.S. Government, and debt securities issued by sovereigns and multilateral development banks – would qualify as "Level 1" assets. Level 1 assets would not be subject to haircuts and could constitute up to 100 percent of a company's portfolio of HQLA.
- Assets considered less liquid and more susceptible to fire-sale discounts or haircuts during times of market stress would make up "Level 2A" and "Level 2B" assets. Level 2A assets would consist primarily of debt securities issued or fully guaranteed by

[3] Enhanced Prudential Standards and Early Remediation Requirements for Foreign Banking Organizations and Foreign Nonbank Financial Companies, 77 Fed. Reg. 76,628 (Dec. 28, 2012).

government-sponsored enterprises and certain debt securities not included in Level 1 assets, and Level 2B assets would consist of certain investment grade corporate debt and equity securities. Level 2A and 2B assets would be subject to 15 and 50 percent haircuts, respectively, with Level 2B assets limited to 15 percent of the total portfolio of HQLA and Level 2A and 2B assets together limited to 40 percent of the total portfolio of HQLA.

Importantly, instruments issued by financial sector entities, including insured depository institutions and insurance companies, as well as mutual funds, would not qualify for inclusion as HQLA. The Agencies believe that instruments issued by financial sector entities are correlated with covered companies and increase wrong-way risk.

The Proposed Rule would also exclude covered bonds, debt securities issued by public sector entities such as states and municipalities, and private-label residential mortgage-backed securities from the definition of HQLA and, in this regard, is more stringent than the Basel III LCR. In addition, corporate debt securities, which are split between Level 2A and Level 2B assets under the Basel III LCR, would be treated as Level 2B assets under the Proposed Rule.

Are There Additional Proposed Requirements Regarding HQLA?

HQLA would be required to: (i) be unencumbered; (ii) not be a client pool security held in a segregated account or cash received from a secured funding transaction involving client pool securities held in a segregated account; (iii) not include any assets, or HQLA generated from an asset, received under a re-hypothecation right if the beneficial owner has a contractual right to withdraw the assets without remuneration at any time during the 30 calendar days following the calculation date; and (iv) not be designated to cover operational costs. Certain additional requirements would apply to assets held in consolidated subsidiaries.

Covered companies also would need to meet certain operational requirements with respect to their portfolio of HQLA. Specifically, covered companies would need to (i) have the operational capability to monetize HQLA; (ii) implement policies that require all HQLA to be under the control of the covered company's management function charged with managing liquidity risk; (iii) appropriately account for total net cash outflows relating to transaction hedging HQLA included in overall HQLA; and (iv) implement and maintain policies and procedures to determine the composition of HQLA on a daily basis.

TOTAL NET CASH OUTFLOWS (DENOMINATOR)

What Would Constitute "Total Net Cash Outflows"?

The Proposed Rule defines "total net cash outflows" for a particular calculation date as the largest difference, as calculated for each of the next 30 days after the calculation date, between a covered company's cumulative inflows and cumulative outflows. **This approach is more stringent than the Basel LCR, which requires banking organizations to hold HQLA against net outflows 30 days after the calculation date.** For example, under the Proposed Rule, if a banking organization's total net cumulative cash outflows on Day 15 after its calculation date were higher than on any other day, this quantity would be deemed the banking organization's total net cash outflows for purposes of its LCR requirement.

How Would Daily Cumulative Inflows and Outflows Be Calculated?

Cumulative inflows and outflows would be calculated by summing inflows and outflows associated with various categories of transactions, including derivatives, retail cash, securities, secured lending and asset exchange and unsecured wholesale cash transactions, excluding transactions with and between consolidated subsidiaries. Cumulative inflows would be capped at 75% of cumulative outflows.

While daily inflows and outflows would generally be calculated on a cumulative basis, *i.e.*, considering only those instruments and transactions with maturity up to and including that day, certain outflows that do not have a maturity date and certain instruments or transactions such as derivatives and brokered deposits would essentially be "frontloaded" into the outflow calculation, potentially increasing the magnitude of the LCR to which a covered company would be subject.

COMPLIANCE AND PHASE-IN

What Would Happen if a Company Failed to Meet Its LCR Requirement?

Under the Proposed Rule, a covered company would need to notify the appropriate Agency if its LCR fell below 100 percent on any business day. If a covered company's LCR fell below 100 percent for three consecutive business days, or if the appropriate Agency determined the company was in material noncompliance with the LCR, the company would need to submit a liquidity plan that included an assessment of its liquidity position, the actions the company has taken and will take to achieve full compliance with the LCR, a plan for remediating operational or management issues that contributed to the

noncompliance, an estimated timeframe for achieving full compliance and a commitment to report to the appropriate Agency no less than weekly until full compliance is achieved.

When Would the LCR Become Effective under the Proposed Rule?

The LCR would become effective beginning January 1, 2015, and would be phased in over a two-year period. From January 1, 2015, through December 31, 2015, covered companies would be required to hold sufficient HQLA to cover 80 percent of total net cash outflows on each day of the applicable period, increasing to 90 percent on January 1, 2016, and 100 percent beginning January 1, 2017. **This phase-in is more stringent than the Basel III LCR, which contemplates a four-year phase-in process stretching from 2015 to 2019, with a 2015 LCR of 60 percent increasing 10 percent a year until 2019.**

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Please do not hesitate to contact us with any questions.

November 1, 2013