

CLIENT UPDATE

BROKER-DEALERS AFFILIATED WITH BANKS MEET THE LCR: FIVE KEY POINTS

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Broker-dealers take note: On September 3, federal banking regulators finalized the much-anticipated liquidity coverage ratio (“LCR”) rules¹ designed to ensure that large banking organizations have sufficient liquid funding sources to withstand a 30-day funding squeeze. Broker-dealer affiliates within these banking organizations engage in businesses that will directly impact calculation of, and compliance with, the ratio, and may be constrained by its enterprise-wide impacts. It is critical for these broker-dealers to understand, and structure their operations efficiently in light of, the LCR implications of their activities.

This note identifies five impacts of the final LCR rules on broker-dealers within affected banking organizations based on our initial impressions. Two of these points show how the final rules limit potential sources of HQLA at the broker-dealer so that the broader banking organization does not benefit from cash and securities that might be available at the broker-dealer. The other three illustrate adverse impacts on traditional broker-dealer activities. Of course, brokerage encompasses many products and services, so we have attempted to include points of broad applicability or that will have a particularly strong impact on a key business line.

¹ Federal Reserve, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, *Liquidity Coverage Ratio: Liquidity Measurement Standards* (Sept. 3, 2014), available at <http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20140903a1.pdf> (“Final Release”).

We expect that further scrutiny of LCR, as well as other prudential bank regulations significantly impacting broker-dealers (such as the revised supplementary leverage ratio, also finalized on September 3), will expose other pressure points for bank-affiliated broker-dealers, and we would be happy to consult on such matters. We plan to issue a more thorough update on LCR in the near future.

We start with a short overview of the basic concept behind the LCR and its calculation in order to provide context. Next, we describe the five key points that we have identified at this early stage, with a short discussion of each.

THE LCR

The final LCR rules require banking organizations to regularly assess their short-term (30 days or less) liquidity needs, and ensure that they have funded those needs with highly liquid assets. Banking organizations must determine their expected 30-day total net cash outflows by adding up their anticipated outflows and subtracting from that amount their expected inflows. The regulations define outflows expansively and make assumptions designed to maximize the total amount of outflows for the calculation. Conversely, expected inflows are more narrowly defined, with assumptions and haircuts that limit the total amount of inflows. As a result, total net cash outflows will always be a positive number.

Once the banking organization has calculated total net cash outflows, it must then determine whether it has enough eligible high-quality liquid assets (“HQLA”) such that the ratio of HQLA (numerator) to total net cash outflow (denominator) equals or exceeds 100%. HQLA fall into three categories, with so-called Level 1 HQLA being the favored type, while Level 2A and Level 2B are progressively less favored, such that, combined, they cannot exceed 40% of total HQLA and Level 2B HQLA cannot comprise more than 15% of total HQLA. Level 2A assets are subject to a 15% haircut, while Level 2B assets are subject to a 50% haircut. In order for any type of HQLA to be eligible for inclusion in the calculation, it must, essentially, be unencumbered and not subject to transfer within 30 days.²

² There are additional requirements, including those mandating that the banking institution have in place proper operational capabilities to monetize assets as well as policies and procedures covering the entire process of determining and maintaining eligible HQLA.

BROKER-DEALERS AND LCR

The LCR applies to banks and bank holding companies (“BHCs”) with at least \$50 billion in total consolidated assets, although those with total consolidated assets below \$250 billion are subject to a less stringent version of LCR. Where a BHC of applicable size has one or more broker-dealer subsidiaries, the activities of those broker-dealers will become part of the consolidated LCR calculation for the BHC. Among other things, the applicable cash outflows and inflows of the broker-dealer will be added to the outflows and inflows of the rest of its affiliates in calculating total net cash outflows for the BHC. Accordingly, the usage of HQLA necessary to support the net cash outflows associated with broker-dealer activities is likely to contribute to decisions about how to conduct these businesses, in much the same way that allocation of regulatory capital has been a factor for subsidiaries of a BHC.

While each broker-dealer is distinct, as a general matter, we expect broker-dealers and their parent BHCs will want to focus on the following five points:

HQLA Held by the Broker-Dealer Is Capped for Usage by the BHC

One expects that, with proprietary trading activities, short-term funding needs and regulatory capital requirements under Securities and Exchange Commission (“SEC”) Rule 15c3-1, broker-dealers would hold the types of securities that qualify as HQLA. When the BHC looks at its HQLA position on a consolidated basis, it would like to take full advantage of HQLA wherever it is available. While the BHC may include eligible HQLA held at a consolidated broker-dealer subsidiary, the final rules in Section 22(b) place a cap on the amount of that HQLA the BHC can utilize in the ratio. In particular, for US consolidated subsidiaries not directly subject to the LCR (which a broker-dealer is not), the cap equals the amount of net cash outflows for such subsidiary on the 30th calendar day after the calculation date plus any additional assets available for transfer to the BHC in times of stress without restriction (including regulatory restrictions such as those pursuant to sections 23A and 23B of the Federal Reserve Act). Accordingly, even if the broker-dealer is rich in HQLA and not subject to the LCR, the BHC may not be able to count all of it towards the ratio calculation. This cap may result in limits on activities, because it will mean that the HQLA gained from those activities may not benefit the BHC’s overall ratio.

Of course, the cap also incentivizes broker-dealer affiliates to maintain strong levels of HQLA even though they are not directly subject to the LCR, because the HQLA supports the broker-dealer’s independent liquidity needs and means that the broker-dealer will not

be a drain on eligible HQLA for the BHC's calculation. We expect firms to closely watch these levels in order to maximize usable HQLA.

Customer Reserve Account Balances Are Not HQLA

The assets included in the different categories of HQLA make clear that not all cash in a consolidated banking organization is created equal for LCR purposes. The only cash that BHCs may treat as HQLA are Federal Reserve Bank balances (and certain foreign reserves). Cash in bank vaults or ATMs does not count towards HQLA. The regulators reasoned that such cash should not qualify as it "may be necessary to meet daily business transactions and due to logistical concerns associated with ensuring that the cash can be immediately used to meet the covered company's outflows."³

The amounts that broker-dealers are required to hold pursuant to SEC Rule 15c3-3 in the customer reserve account also will not qualify as eligible HQLA. The regulators adopted this approach because these monies "are not freely available to the covered company to meet its liquidity needs and are not considered unencumbered for purposes of the final rule."⁴ This decision removes another source of cash (or US treasuries) from usage as HQLA. However, the final rule did provide for a modest use of the customer reserve monies when calculating inflows. The projected decrease in the customer reserve account requirement over the next 30 days may be treated as an inflow. Such projection is calculated by reference to the outflow and inflow patterns observed in the rest of the net outflow calculation for the broker-dealer.

Prime Brokerage Deposits Receive Less Favorable Outflow Treatment

In calculating outflows to arrive at the net outflow denominator of the ratio, various types of outflows are aggregated. Each category of potential outflow is multiplied by a specified percentage to determine how much of the amount of that category must be included in the outflow calculation. For example, certain deposits are treated as relatively "stickier" than others, because they are seen as less likely to be subject to a "run" under stressed conditions. Thus, outflow rates for deposits that meet the definition of "operational deposits" (viewed as "sticky") generally are multiplied by a lower percentage (meaning that a smaller percentage of them will count toward LCR outflows) than outflows not involving operational deposits (viewed as more likely subject to prompt withdrawal). Of particular interest to broker-dealers, the final rules specifically exclude deposits in connection with prime brokerage services from qualifying as operational deposits, with

³ Final Release at 63.

⁴ *Id.* at 111.

the result that such amounts might be counted as up to 100% outflows. This result holds even where the monies are allocated to the customer reserve account under Rule 15c3-3.

Rehypothecation of Margin Collateral Results in No Inflow

Secured lending transactions by a broker-dealer to a customer, including margin loans made to customers, may result in an inflow. However, inflow treatment is not available where the broker-dealer rehypothecates the collateral securing the margin loan (as it is permitted to do under the securities laws), and the collateral will not be returned within 30 days of the calculation date. As the 30-day period will be key to those borrowing securities with the idea of using them as HQLA, broker-dealers may find mismatches in their desire to lend securities for shorter periods and counterparties' desire to borrow securities for longer periods (to count assets as HQLA).

Outflow from Customer Short Positions Covered by Other Customer Collateral

Broker-dealers often use one customer's margin collateral to lend to another customer seeking to sell short the same security. This funding source benefits broker-dealers because it is relatively inexpensive and allows them to earn additional revenue from both customers with respect to the same asset. With the final rules, however, this transaction generally will result in an outflow to the broker-dealer equal to 50% of the funds received from the customer's short sale. As such, it increases the cost of funding for the broker-dealer by adding to net cash outflows and requiring additional HQLA, with the strongest effects on the prime brokerage business, which makes extensive use of client margin collateral in this manner.

CONCLUSION

The impacts described above will increase costs to broker-dealers by requiring additional liquidity sources to support core activities. Many other aspects of the LCR not discussed above will impose further costs. Broker-dealers should evaluate these issues quickly in order to assess, and find ways to meet, their new funding needs.

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Please do not hesitate to contact us with any questions.

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