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Federal Reserve Board Proposes Stricter Bank Liquidity Rules

Proposed rules include a shorter transition period, a narrower definition of what qualifies as "high quality liquid assets," and a more stringent liquidity stress-testing methodology than the framework issued by the Basel Committee on Banking Supervision.

On October 24, the Board of Governors of the Federal Reserve System proposed rules[1] (Proposed Liquidity Rules) that would implement a modified version of the Basel Committee on Banking Supervision's (Basel Committee's) liquidity coverage ratio (LCR) framework.[2] The Proposed Liquidity Rules would also establish an enhanced prudential liquidity standard consistent with section 165 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) for the largest U.S. financial institutions. The Proposed Liquidity Rules are designed to strengthen the ability of the largest U.S. financial institutions to withstand periods of market stress on a par with the 2008 financial crisis by pushing them to hold enough safe assets to fund operations for 30 days if other sources of funding are not available. The Proposed Liquidity Rules are intended to be one of several requirements that the federal banking agencies are considering to improve the ability of large U.S. financial institutions to withstand a tightening of credit without governmental intervention.[3]

The other federal banking agencies—the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation—are expected to publish the Proposed Liquidity Rules for comment by November 2013. The Proposed Liquidity Rules will be open for public comment for 90 days, or until January 31, 2014, and, if adopted, would be phased in beginning in January 2015.

Which financial institutions will be subject to the Proposed Liquidity Rules?

The Proposed Liquidity Rules would be applicable to the following:

- All internationally active banking organizations (banking organizations with **$250 billion or more in total assets or $10 billion or more in on-balance-sheet foreign exposure**).
- Consolidated subsidiary depository institutions of internationally active banking organizations with **$10 billion or more in total consolidated assets** (collectively, covered banking organizations).
- Covered nonbank companies and consolidated subsidiary depository institutions of covered nonbank companies with **$10 billion or more in total consolidated assets** (collectively, with covered banking organizations and covered nonbank companies, covered companies).
- Bank holding companies and savings and loan holding companies without significant insurance or commercial operations that, in each case, have **$50 billion or more in total consolidated assets** but are not covered

1. *See* Notice of Proposed Rulemaking, Liquidity Coverage Ratio: Liquidity Risk Measurement, Standards, and Monitoring (Oct. 24, 2013), *available at* http://www.federalreserve.gov/FR_notice_lcr_20131024.pdf. Other banking agencies shortly will propose substantially similar rules.

2. The Basel Committee's LCR framework establishes, for the first time, an internationally harmonized quantitative liquidity standard that has the primary objective of promoting the short-term resilience of the liquidity risk profile of internationally active banking organizations.

3. *See, e.g.,* Open Board Meeting, Liquidity Coverage Ratio: Liquidity Risk Measurement, Standards, and Monitoring (Oct. 24, 2013) (statement of Gov. Daniel K. Tarullo) (indicating that the Federal Reserve is working to establish a net stable funding ratio, which would create a one-year structural funding requirement, and some form of regulatory charge tied to a financial institution's reliance on short-term wholesale funding), *available at* http://www.federalreserve.gov/newsevents/press/bcreg/tarullo20131024a.htm.

companies for purposes of the Proposed Liquidity Rules. Such banks, however, would be subject to a modified LCR, as discussed below.

How is the LCR calculated under the Proposed Liquidity Rules?

Under the Proposed Liquidity Rules, a covered company would calculate its LCR by dividing the amount of its high quality liquid assets (HQLA) by its total net cash outflows, which would be equal to the **highest daily amount of cumulative net cash outflows** within the 30 calendar days following a calculation date (30-day stress period). Banks that have more than $50 billion in assets and that are under the $250 billion threshold would be subject to a modified LCR based on a 21-calendar-day, rather than a 30-calendar-day, stress scenario.

A covered company's total net cash outflow amount would be determined by applying outflow and inflow rates, which reflect certain stressed assumptions, against the balances of a covered company's funding sources, obligations, and assets over a prospective 30-day period. The measures of total cash outflow and total cash inflow, and the outflow and inflow rates used in their determination, are meant to reflect aspects of the stress events experienced during the recent financial crisis.

What are the HQLA categories under the Proposed Liquidity Rules?

As is done under the Basel Committee's LCR framework, the Proposed Liquidity Rules divide HQLA into three categories of assets: Level 1, Level 2A, and Level 2B, as described below.

Level 1 assets are the very high quality and highly liquid assets and include the following: (1) Federal Reserve Bank balances; (2) foreign withdrawable reserves; (3) certain U.S. Treasury securities; (4) certain liquid and readily marketable[4] U.S. government agency securities; (5) certain liquid and readily marketable sovereign and multilateral organization securities; and (6) certain debt securities issued by sovereign entities.

Level 2A and 2B assets have characteristics that are associated with being relatively stable and significant sources of liquidity but not to the same degree as Level 1 assets. Accordingly, Level 2A assets would be subject to a 15% haircut and, when combined with Level 2B assets, could not exceed 40% of the total stock of HQLA. Level 2B assets, which are associated with a lesser degree of liquidity and more volatility than Level 2A assets, would be subject to a 50% haircut and could not exceed 15% of the total stock of HQLA.

Level 2A assets include certain claims on, or claims guaranteed by, a U.S. government–sponsored enterprise and certain claims on, or claims guaranteed by, a sovereign entity or a multilateral development bank that are liquid and readily marketable and subject to certain conditions.

Level 2B assets would include certain publicly traded corporate debt securities and publicly traded shares of common stock that are liquid and readily marketable.

What are the transition periods for the Proposed Liquidity Rules?

The Proposed Liquidity Rules would be effective as of January 1, 2015 but would be subject to the following transition periods:

- January 1, 2015: Covered companies must have a minimum LCR of 80%.
- January 1, 2016: Covered companies must have a minimum LCR of 90%.
- January 1, 2017 and thereafter: Covered companies must have a minimum LCR of 100%.

These transition periods are more accelerated than those provided under the Basel Committee's LCR framework,

4. Under the Proposed Liquidity Rules, an asset would be liquid and readily marketable if it is traded in an active secondary market with more than two committed market makers, a large number of committed non–market maker participants on both the buying and selling sides of transactions, timely and observable market prices, and high trading volumes.

which contemplates an initial LCR of 60% on January 1, 2015 and a 100% LCR by January 1, 2019.

What are the differences between the Basel Committee's LCR framework and the Proposed Liquidity Rules?

The Proposed Liquidity Rules differ in three important respects from the Basel Committee's LCR framework. First, the Proposed Liquidity Rules would require covered companies to fully comply with the new LCR requirements two years earlier than under the Basel Committee's LCR framework. Second, the Proposed Liquidity Rules include a narrower definition of what qualifies as HQLA. For example, the Proposed Liquidity Rules do not permit covered bonds and securities issued by public sector entities, such as a state, local authority, or other government subdivision below the level of a sovereign (including U.S. states and municipalities), to qualify as HQLA. Third, the proposal would also use the highest daily amount of cumulative net cash outflows within a 30-day stress period as the denominator of LCR (rather than using total cash outflows over a 30-day stress period, which is the method employed by the Basel Committee's LCR framework).

Conclusion

The Proposed Liquidity Rules are expressly designed to implement the Basel Committee's LCR framework in the United States—as well as the qualitative liquidity requirements of Dodd-Frank section 165—and, in that respect, were entirely expected. The proposal, however, does contemplate a regulatory liquidity framework that, in certain important respects, is more stringent than the Basel Committee's international counterpart, including a narrower bucket of assets that qualify as HQLA, a shorter transition period, and a more rigorous stress-testing methodology. In addition, the Proposed Liquidity Rules would apply to a somewhat larger universe of U.S. banking organizations than those that would be technically subject to the Basel Committee's LCR framework. At the same time, the Basel Committee did invite member jurisdictions to consider applying the LCR requirements to a broader population of banks. This type of more stringent action by the U.S. regulatory agencies continues the general U.S. regulatory trend, which, since the 2008 financial crisis, has demonstrated tightening prudential requirements and restrictions beyond those that may be required at the international level. That being said, sectors of the U.S. banking industry may question the potential economic costs and competitive disparities raised by these proposals.

The Proposed Liquidity Rules are just the first of two key Basel Committee liquidity requirements to be proposed. The other key requirement, the net stable funding ratio (NSFR), is generally designed to require banking organizations to fund their activities with stable sources of liquidity over a one-year time horizon. The NSFR, however, is still under development and observation by the Basel Committee, and a proposed NSFR by the U.S. bank regulatory agencies is not likely to be forthcoming in the near future.

Financial institutions that will be subject to the Proposed Liquidity Rules should consider the potential impact to their operations and consider providing comments prior to the January 31, 2014 deadline.

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