

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Date: August 29, 2014
To: Board of Governors
From: Daniel Tarullo 
Subject: Draft Notice of Final Rulemaking to Implement a Liquidity Coverage Ratio Requirement

Attached are a memorandum to the Board and a draft *Federal Register* notice of final rulemaking that would implement a minimum liquidity coverage ratio (LCR) requirement for certain large bank holding companies, savings and loan holding companies, and depository institutions. This final rule implements the international LCR standard established by the Basel Committee on Banking Supervision and will help strengthen the resilience of our large financial institutions and the broader U.S. financial system. The LCR will be an effective supervisory tool and should contribute to reducing dependence by banks on the central bank as a lender of last resort. The draft final rule would require the largest banking organizations to maintain high-quality liquid assets (HQLA) equal to projected stressed cash outflows over a 30 calendar-day stressed scenario; a less stringent LCR requirement (modified LCR) would apply to certain smaller depository institution holding companies with \$50 billion or more.

The most significant changes from the proposal include the provision of a phase in of the daily LCR calculation requirement for the largest firms and a change from daily to a monthly calculation for firms subject to the modified LCR. The final rule would also revise the proposed methodology for measuring maturity mismatches within the 30-day stressed period, and would expand the pool of publicly-traded common equity shares that can be included as HQLA. The final rule would address commenter concerns about the treatment of secured public sector deposits by treating them equally or in some cases more favorably relative to unsecured public sector deposits. Like the proposal, the final rule would not include municipal securities as HQLA; however, staff recommends developing a new proposal for public comment that would allow the most liquid municipal securities to be included as HQLA. Lastly, the final rule would not apply to nonbank financial companies designated for Board supervision by the Financial Stability Oversight Council

as was the case in the proposal. Instead, it is anticipated that the Board would apply enhanced liquidity requirements to such firms through rule or order.

The final rule would be published jointly by the Board, FDIC, and OCC in the Federal Register after all agencies have completed internal review and approval procedures.

The Committee on Bank Supervision has reviewed the final rule, and I believe it is ready for the Board's consideration.

Attachments

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Date: August 29, 2014
To: Board of Governors
From: Staff¹
Subject: Draft final rule to implement a liquidity coverage ratio requirement

ACTIONS REQUESTED: Staff seeks the Board's approval of the attached draft final rule that would implement a minimum liquidity coverage ratio (LCR) requirement for certain large bank holding companies, savings and loan holding companies (together with bank holding companies, depository institution holding companies), and depository institutions. The draft final rule would be issued jointly by the Board, Federal Deposit Insurance Corporation (FDIC), and the Office of the Comptroller of the Currency (OCC) (collectively, the agencies) after each agency has completed its internal review and approval procedures. Staff also recommends that the Board develop a new proposal for public comment to treat highly liquid municipal securities as high-quality liquid assets (HQLA) for purposes of the LCR requirement. Staff also requests authority to make technical, non-substantive changes to the attached draft final rule in order to respond to comments from the Federal Register or to incorporate changes requested by the agencies as part of the approval process.

EXECUTIVE SUMMARY:

- The draft final rule would apply an LCR requirement to banking organizations with total consolidated assets of \$250 billion or more or total consolidated on-balance sheet foreign exposure of \$10 billion or more, and their subsidiary depository institutions with \$10 billion or more of total consolidated assets (covered companies). It would apply a simpler, less stringent LCR requirement to depository institution holding companies with \$50 billion or more in total consolidated assets that are not covered companies (modified LCR companies). The draft final rule would not apply to nonbank financial companies designated by the

¹ Messrs. Gibson, Van Der Weide, Lindo, Emmel, Littler, and Trost, and Mss. Hewko and Horsley (Division of Banking Supervision and Regulation), and Messrs. Alvarez and Atieh, and Mss. Snyder and Stewart (Legal Division).

Financial Stability Oversight Council (FSOC) for Board supervision or to depository institution holding companies with total assets of less than \$50 billion.

- The draft final rule is substantially similar to the proposal, with modifications in response to comments to change the methodology for capturing maturity mismatches between outflows and inflows; modify transition periods to provide firms time to comply with daily reporting requirements; broaden the recognition of certain debt and equity securities as HQLA; and adjust the treatment of specific categories of cash inflows and outflows.
- The draft final rule would require covered companies to maintain HQLA equal to projected stressed cash outflows over a 30 calendar-day stressed scenario, which for covered companies would include a measure of maturity mismatch.
- Under the draft final rule, the LCR requirement for modified LCR companies would include stressed cash outflows over a 30 calendar-day stressed scenario that are reduced by 30 percent to reflect their smaller size and generally less complex balance sheets.
- The phase-in of the minimum LCR requirement for covered companies remains consistent with the proposal: 80 percent starting January 1, 2015, 90 percent starting January 1, 2016, and 100 percent starting January 1, 2017. However, covered companies will be given additional time to comply with the daily reporting requirements, and will be permitted to calculate their LCR monthly during this transition period. Additionally, modified LCR companies will not be subject to the rule until January 1, 2016, and will be required to calculate their LCR monthly, rather than the daily calculation that was proposed.
- Staff estimates that, if the draft final rule were currently in effect and fully phased-in, all covered depository institution holding companies and modified LCR companies would be required to hold an aggregate of approximately \$2.5 trillion of HQLA, with a shortfall for firms that currently do not meet the standard of approximately \$100 billion. Staff estimates that the majority (approximately 70 percent) of covered depository institution holding companies and modified LCR companies would currently meet an LCR requirement of 100 percent if the draft final rule were currently in effect and fully phased-in.

DISCUSSION: The recent financial crisis demonstrated significant weaknesses in the liquidity positions of banking organizations. This experience highlighted the need for enhanced liquidity risk management practices to address the pervasive detrimental effects a liquidity crisis can have on the banking sector, the financial system, and the economy as a whole. On October, 24 2013,

the Board approved a notice of proposed rulemaking (NPR)² seeking public comment on the implementation of the LCR in the United States. The NPR was largely consistent with the LCR standard issued by the Basel Committee on Banking Supervision (Basel III LCR);³ however, it diverged from the Basel III LCR in several areas to reflect the circumstances and characteristics of the U.S. market.

The Board received 96 discrete comment letters and 23 form letters on the NPR. While many commenters supported the overall proposal, a number of commenters criticized specific aspects of the NPR, and others requested clarification on, or suggested modifications to, certain sections of the NPR. Staff has reviewed the comments and recommends modifying the proposed requirements to address certain commenter concerns, as reflected in the draft final rule. A summary of the comments is attached.

A. Summary of Significant Changes from the NPR

1. **Scope of Application**. The draft final rule would no longer apply to financial companies designated by the FSOC for Board supervision.⁴ (See pp. 27-28.)
2. **Transition Period**. To provide sufficient time for firms to build internal systems to comply with the rule, the daily LCR calculation requirement would begin for the largest, most systemically important covered companies (covered depository institutions with \$700 billion or more in total consolidated assets or \$10 trillion or more in assets under custody) on July 1,

² The NPR was published jointly by the agencies in the Federal Register on November 29, 2013. See 78 FR 71818 (November 29, 2013).

³ The Basel Committee on Banking Supervision (BCBS) issued new international liquidity standards as part of the December 2010 agreement on capital and liquidity known as “Basel III.” The Basel III standards included the Basel III LCR, which was designed to enhance the ability of banking organizations to withstand liquidity shocks arising from market and economic stress by requiring them to hold an amount of unencumbered HQLA sufficient to survive an acute 30 calendar-day stress scenario. See “Basel III: International framework for liquidity risk measurement, standards and monitoring” (December 2010), available at <http://www.bis.org/publ/bcbs188.pdf>; see also BCBS, “Basel III: The Liquidity Coverage Ratio and liquidity risk monitoring tools” (January 2013), available at <http://www.bis.org/publ/bcbs238.htm>.

⁴ The preamble to the draft final rule notes that the Board would by rule or order apply tailored enhanced liquidity standards to nonbank financial companies designated by the FSOC.

2015. Other covered companies (those with \$250 billion or more in total consolidated assets or \$10 billion or more in total on-balance sheet foreign exposure, but less than \$700 billion in assets or \$10 trillion or more in assets under custody) would be required to calculate their LCR on a daily basis beginning July 1, 2016. Prior to these dates, covered companies would be required to calculate their LCR at the end of each month, beginning January 1, 2015. In addition, under the draft final rule, modified LCR companies are required to calculate their LCR only at the end of each month, beginning January 1, 2016. (See pp. 294-301.)

3. **LCR Numerator.**

- a. The draft final rule would remove the proposed requirement that corporate debt securities be publicly traded on a national securities exchange to qualify for inclusion as a level 2B liquid asset. Instead, any investment grade corporate debt security that is issued by a company that is not a financial sector entity and that has a proven record as a reliable source of liquidity may be included as level 2B liquid assets. (See pp. 77-79.)
- b. The draft final rule would expand the pool of publicly traded common equity shares that may be included as level 2B liquid assets to include publicly traded common equity shares in the Russell 1000 Index, rather than the more limited S&P 500 Index, as was proposed. (See pp. 79-85.)
- c. To prevent a covered company from being able to manipulate its HQLA amount by engaging in secured transactions, such as certain repurchase or reverse repurchase transactions, the proposed rule would have required a covered company to calculate all applicable asset caps and haircuts at the start and at the end of the 30 calendar-day period. The draft final rule maintains this requirement, but, to address commenters' concerns with respect to state and municipal deposits, which are commonly collateralized, as well as certain collateralized corporate trust deposits, the draft final rule would exclude these secured deposits from this calculation. (See pp. 125-128.)

4. **Municipal Securities.** The draft final rule would not include municipal securities as HQLA. However, based on market data and information received from commenters, certain municipal securities appear to be highly liquid. Thus, staff recommends that the Board develop a proposal for public comment to include highly liquid municipal securities as HQLA. (See pp. 87-91.)

5. **LCR Denominator**. The draft final rule revises the methodology for measuring maturity mismatch within the 30 calendar-day stress horizon to focus more explicitly on outflows and inflows with contractual maturity dates as well as overnight funding from financial institutions. As part of that calculation, the proposed rule would have assumed that outflows with no specified maturity occur on the first day of the 30 calendar-day period. The draft final rule eliminates this assumption. (See pp. 136-142.)
6. **Modified LCR**. The draft final rule changes the approach to the modified LCR to address comments received. The draft final rule would require net cash outflows to be calculated over a 30 calendar-day period, rather than the proposed 21 calendar-day period to address commenter's operational concerns that the 21 calendar-day timeframe does not align well with existing systems and processes. However, to maintain a similar reduction in the stringency of the LCR requirement for the less complex companies, the minimum LCR requirement for modified LCR companies would effectively be 70 percent rather than 100 percent of the enhanced LCR requirement. Under the draft final rule, companies subject to the modified LCR would be subject to the rule starting January 1, 2016, with a requirement to calculate their LCR on a monthly basis rather than the proposed daily calculation. (See pp. 302-308.)

B. Explanation of Final Rule and Significant Changes from NPR

Other important provisions of the draft final rule are discussed below. Some incorporate changes to address issues raised by commenters.

1. Scope of Application (See pp. 23-33.)

Consistent with the proposed scope of application, the draft final rule would apply to banking organizations with \$250 billion or more in total consolidated assets or \$10 billion or more in total on-balance sheet foreign exposure, as well as their subsidiary depository institutions with \$10 billion or more in total consolidated assets (covered companies). The draft final rule would also apply a less stringent LCR requirement to top-tier bank holding companies and savings and loan holding companies with \$50 billion or more in consolidated total assets that are not covered companies and do not have substantial insurance or commercial operations (modified LCR companies).

A few commenters expressed concern regarding the threshold for defining the covered companies subject to the most stringent LCR requirements. Several commenters requested that the threshold for covered companies subject to the more stringent LCR be increased from \$250 billion in total consolidated assets or \$10 billion in total on-balance sheet foreign exposure, arguing that the proposed LCR would apply to several banking organizations with business models, operations, and funding profiles more similar to smaller banking organizations that would be subject to the modified LCR.

The proposed covered company threshold was calibrated to capture companies with the largest liquidity risk profiles. These firms generally engage in a variety of lending and market operations, are relatively interconnected, and rely on different sources of funding. To the extent there may be differences in the composition of assets or liquidity needs among these firms, the draft final rule adjusts an institution's LCR requirement based on the composition of the organization's balance sheet, off-balance sheet commitments, business activities, and funding profile. Generally, institutions with less complex balance sheets and less risky funding profiles will have lower net cash outflows and will be able to comply with the LCR by holding less HQLA than institutions with more complex balance sheets and that use riskier sources of funding. Therefore, staff recommends adopting the NPR's scope of application for banking organizations in the final rule as proposed.

The proposal would have applied to all nonbank financial companies designated by the FSOC that do not have significant insurance operations. The draft final rule would not apply to these companies. Instead, staff recommends that the Board apply enhanced liquidity standards to these institutions through rule or order following an evaluation of the business model, capital structure, and risk profile of each designated nonbank financial company.

2. *Minimum Quantitative Liquidity Requirements and Transition Period* (See pp. 34-41; 294-301.)

The proposed rule included a transition period that was shorter than that set forth in the Basel III LCR, which delayed the requirement that companies maintain an LCR of 100 percent until January 1, 2019. The NPR also would have required covered companies to calculate their LCR daily upon the effective date of the LCR requirement. Commenters expressed concern with the proposed transition period, requesting that the final rule adopt the Basel III LCR schedule and provide more time to comply with the new requirements. Commenters also argued that the

proposed daily calculation requirement and transition period would be operationally challenging and overly burdensome.

Staff recommends retaining the accelerated implementation timeframe as proposed for covered companies because of the importance of the LCR in promoting financial stability. Moreover, most covered companies already meet the liquidity requirements in the rule and the proposed implementation schedule would help sustain the strong liquidity positions many covered companies have achieved since the recent financial crisis. For those depository institution holding companies that do not meet the LCR requirement, the overall shortfall (about \$100 billion) is relatively modest and the final rule provides a three-year transition period (the same length as the Basel III LCR).

However, staff also recommends a transition period for the daily calculation requirement, differentiating the transition period based on the size, complexity, and potential systemic impact of covered companies. The draft final rule would provide a short transition period for daily LCR calculations for the largest institutions with \$700 billion or more in total consolidated assets or \$10 trillion or more in assets under custody, and any depository institution with total consolidated assets equal to \$10 billion or more that is a consolidated subsidiary of such a depository institution holding company. The requirement to calculate the daily LCR would be delayed six months to July 1, 2015 for these covered companies; they would be required to begin to calculate the LCR monthly on January 1, 2015. This transition period is consistent with the scope of application for the FR 2052a report, which requires daily liquidity reporting by these institutions.

The draft final rule allows all other covered companies to calculate their LCR monthly from January 1, 2015 to June 30, 2016, and delays the daily LCR calculation requirement until July 1, 2016. The draft final rule would delay the overall compliance date for modified LCR companies until January 1, 2016, to ease the operational burden of complying with a new standard, and would require them to calculate the LCR only on a monthly basis.

3. *LCR Numerator: HQLA* (See pp. 41-133.)

Consistent with the proposal, the draft final rule sets criteria for categories of assets that qualify as HQLA. The draft final rule would divide HQLA into three categories of assets: level 1, level 2A, and level 2B liquid assets. Level 1 liquid assets include cash and U.S. Treasuries, which are the highest quality and most liquid assets. These assets may be included in

a covered company's HQLA amount without limit and without haircuts.⁵ Level 2A liquid assets include securities issued by U.S. government-sponsored enterprises and are subject to a 15 percent haircut.⁶ Level 2B liquid assets include certain corporate debt and equity securities and are subject to a 50 percent haircut.⁷ Level 2A and level 2B liquid assets together may not exceed 40 percent of the total HQLA amount and level 2B liquid assets alone may not exceed 15 percent of the total HQLA amount.

To qualify as eligible HQLA under the draft final rule, assets would also have to be unencumbered and able to be efficiently monetized during a period of stress, so that a banking organization has a reasonable degree of certainty that it could obtain funds quickly with the assets. Consistent with the proposal, the final rule generally requires a security to be liquid and readily marketable to be included as HQLA.

Many commenters expressed concerns relating to the treatment in the NPR of secured public sector and corporate trust deposits (together, collateralized deposits). The NPR would have included the collateral securing collateralized deposits within the 40 percent limit on level 2 liquid assets and a 15 percent limit on level 2B liquid assets and would have assumed the immediate return of level 2 collateral securing the deposit, potentially increasing the LCR requirement with respect to those deposits. This treatment is the consequence of a general rule that applied to all secured liabilities that are secured by HQLA with no, or short-term, maturity dates, such as overnight repurchase agreements. Because collateralized deposits have demonstrated a tendency to be a relatively more resilient source of secured funding during times of market stress, the draft final rule would not require that collateral securing collateralized deposits be subject to the draft final rule's assumption relating to the immediate return of level 2 collateral.

As noted above, the proposal would have permitted corporate debt securities to be included as level 2B liquid assets if the debt securities were publicly traded on a national exchange. Commenters argued that this limitation would exclude many otherwise liquid corporate debt securities that are not traded on a national exchange. Staff recommends changing

⁵ See § __.20(a) of draft final rule; see pp. 59-69 of draft Supplementary Information section.

⁶ See § __.20(b) of draft final rule; see pp. 69-76 of draft Supplementary Information section.

⁷ See § __.20(c) of draft final rule; see pp. 76-86 of draft Supplementary Information section.

the HQLA criteria in response to this comment to permit corporate debt securities that meet the other criteria for level 2B liquid assets, which are more reflective of a security's liquidity, to be included as HQLA. These criteria require that the corporate debt securities be investment grade, not be issued by a company that is a financial sector entity, and be from an issuer that has a proven record as a reliable source of liquidity.

In addition, staff recommends referencing the Russell 1000 Index rather than the S&P 500 Index in identifying equity securities that may be included as HQLA. These equity securities would qualify as level 2B liquid assets. The equity securities on the Russell 1000 evidence similar trading volumes, volatilities, and price movements to the equity securities on the S&P 500 Index. Moreover, equity securities that are included in the Russell 1000 index are selected based on predetermined criteria, whereas a committee evaluates and selects equity securities for inclusion in the S&P 500 Index. The systematic selection of equity securities for inclusion in the Russell 1000 index, combined with the liquidity characteristics of equity securities included in the index, would support replacing the S&P 500 Index with the Russell 1000 Index in the criteria for level 2B liquid assets.

4. Municipal Securities (See pp. 87-91.)

The NPR did not include municipal securities as HQLA because of the generally low-liquidity of municipal securities. Many commenters requested that municipal securities (which includes securities issued by states and political subdivisions thereof) be permitted to qualify as HQLA. These commenters were concerned that the exclusion of municipal securities from HQLA could lead to higher funding costs for states and municipalities.

Data on trading of municipal securities indicates that a limited number of municipal securities appear to be traded regularly. However, while many securities issued by states and municipalities have strong credit risk characteristics, the liquidity characteristics of these securities range significantly, with most securities issued by public sector entities exhibiting low average daily trading volumes and limited liquidity, particularly under stressed economic scenarios.

The goal of the LCR is to ensure that large financial firms are able to meet their short-term liquidity needs during times of stress. Inability to meet those liquidity needs proved to be a significant cause of the failure or near failure of several large financial firms during the recent financial crisis. A key component of adequate liquidity is the availability of assets that are

readily saleable to meet obligations as they come due. Thus, the important systemic objectives of the HQLA requirements can only be met by assets that are and remain highly liquid.

The information provided by commenters suggest that some municipal securities may meet this objective. Accordingly, staff recommends that the Board develop a new proposal for public comment to include highly liquid municipal securities as HQLA.

5. *LCR Denominator: Net Cash Outflows* (See pp. 133-289.)

i. Net cash outflows calculation mechanics (See pp. 134-152.)

The draft final rule would define the total net cash outflows for the purpose of the denominator of the LCR as the difference between the outflows and inflows over a 30 calendar-day period, with an adjustment to address mismatches in timing of outflows and inflows. Inflows that can be included to offset outflows are capped at 75 percent of the total outflows, which would ensure that some amount of HQLA will be held by a covered company to meet unexpected potential outflows. Consistent with the proposal, the draft final rule would apply a standardized set of outflow and inflow rates against various asset and liability balances, together with off-balance sheet commitments. Lower outflow rates would be assigned to sources of funding associated with lower liquidity risk (such as retail deposits) and higher outflow rates would be assigned to sources of funding that have been observed to quickly diminish during a liquidity crisis (such as overnight borrowing from financial institutions).

The proposed rule would have addressed maturity mismatches within the 30 calendar-day period by requiring firms to calculate cumulative net cash outflows for each day within the 30 calendar-day period. As part of that calculation, the proposed rule would have assumed that outflows with no specified maturity occur on the first day of the 30 calendar-day period. Many commenters argued that this assumption was overly conservative and unduly burdensome.

The draft final rule eliminates this assumption. Instead, the draft final rule would capture the liquidity risk of maturity mismatches by focusing on instruments with a contractual maturity and on overnight transactions with financial entities. This change appropriately addresses commenters' concerns while still capturing the liquidity risk of maturity mismatches by

calculating net cash outflows that reflect a covered company's highest estimated liquidity need during the 30 calendar-day period.⁸

ii. Outflow rate changes (See pp. 152-263.)

Commenters asserted that outflow rates assigned to many categories of funding were too high. The outflow rates under the NPR and draft final rule were calibrated based on a substantial amount of supervisory data collected from U.S. financial institutions and based on historical data observed during the recent financial crisis. These outflow and inflow rates are designed to address the liquidity and funding risks for U.S. firms, including both idiosyncratic and systemic stresses across a range of financial institutions. This data showed that during periods of significant financial stress, customers of covered companies tended to rapidly withdraw large amounts of funding from the financial system to meet their obligations in amounts that are consistent with the outflow rates that the agencies' proposed in the NPR and are considering under the draft final rule. Therefore, consistent with this data, the draft final rule would not change the vast majority of the outflow and inflow rates from the NPR. Nevertheless, to address particular concerns raised by commenters, the draft final rule would change certain of the proposed outflow rates, as highlighted below.

With respect to the outflow and inflow rates assigned to unsecured transactions, the NPR would have required firms to determine the counterparty type to assign the applicable rate. Thus, under the NPR, unsecured transactions with financial counterparties would have received substantially higher outflow rates than unsecured transactions with non-financial counterparties due to the difference in the liquidity risk profile of financial sector entities and traditional corporate entities. However, with respect to secured transactions the NPR would have applied an outflow rate solely by collateral type. As the quality of collateral increases, the assigned outflow rate would decrease. Commenters argued that under certain circumstances a secured funding transaction from a wholesale, non-financial counterparty could result in a higher outflow rate than an unsecured funding transaction with that same counterparty. The draft final rule would address the commenters' concern by establishing that the unsecured funding transaction outflow

⁸ Other than certain unsecured transactions with financial sector entities and open secured transactions, which are assumed to mature on the first calendar day after the calculation date, the final rule would assume that all other non-maturity transactions mature within 30 calendar days of the calculation date, but would not assign a specific maturity date.

rate for a wholesale counterparty would be the maximum outflow rate for that counterparty, regardless of whether a higher secured funding transaction outflow rate would have applied.

The NPR would have applied a 100 percent outflow rate to all commitments to SPEs. Commenters argued that some SPEs do not exhibit the types of liquidity risks that would warrant a 100 percent outflow rate. Rather, commenters contended that those SPEs behave similarly to the entity that sponsored the SPE. The draft final rule revises the outflow rates for commitments to apply the 100 percent outflow rate only to special purpose entities (SPEs) that rely on market funding (the issuance of securities or commercial paper). These SPEs are highly susceptible to stressed market conditions and may be unable to refinance maturing securities and commercial paper that they have issued, and are, therefore, expected to have higher outflow rates.

Lastly, the NPR would have provided reduced outflow rates for certain wholesale deposits that are placed by the customer in connection with the covered company's provision to the customer of certain services, such as those related to clearing, custody, and cash management (operational deposits). These reduced outflow rates were intended to recognize the increased likelihood that customers would maintain their deposits with the covered company in connection with obtaining operational services. Commenters argued that many other services provided by financial firms could also result in lower outflow rates by customers. The draft final rule would add certain collateral and payment processing services provided by covered companies to the definition of operational services that result in lower outflow rates. In addition, the draft final rule provides that deposits related to services in providing custody banking services as agent or administrator would qualify for lower outflow rates.

6. Modified LCR (See pp. 302-309.)

The NPR proposed to apply a modified LCR requirement to depository institution holding companies with total consolidated assets of \$50 billion or more that are not covered companies (modified LCR companies). These are generally smaller banking organizations that have less complex liquidity funding structures than covered companies. Generally, modified LCR companies are neither exposed to the same level of liquidity risks, nor engaged in activities of the same systemic nature as covered companies; thus, the financial system should be better able to absorb a liquidity stress event at one of these institutions. In addition, their smaller size, lower foreign exposure, and less complex activities should make these firms less difficult to resolve in times of stress.

The proposed modified LCR would have been a simpler, less stringent form of the LCR than the 30-day computation applied to covered companies and would have imposed outflows based on a 21 calendar-day rather than a 30 calendar-day stress scenario. Additionally, outflow rates for products with no specified maturity generally would have been weighted at 70 percent of the LCR's outflow rates under the modified LCR for purposes of determining the appropriate level of HQLA. Many commenters supported differentiating and tailoring requirements for modified LCR companies based on size and complexity, but many commenters also expressed concerns about the operational complications of calculating a 21 calendar-day LCR as opposed to a 30 calendar-day LCR under existing systems and processes.

In light of the comments, the draft final rule would apply a modified LCR over a 30 calendar-day period, but would retain the 70 percent factor for the net cash outflows as calculated in the LCR. This adjustment produces a quantitatively similar result relative to the proposal, while reducing operational burden on firms subject to the modified LCR. Additionally, as in the NPR, the modified LCR in the draft final rule would not require firms to identify maturity mismatch within the 30 calendar-day stress period.

C. Impact Analysis

Staff estimates that the majority of covered depository institution holding companies (approximately 70 percent) subject to the LCR and modified LCR would currently be compliant with a 100 percent LCR requirement if the draft final rule were currently in effect and fully phased-in. These firms have improved their liquidity positions significantly over the past few years. For firms that would not meet the 100 percent LCR requirement if the draft final rule were currently in effect and fully phased-in, the liquidity shortfall at covered depository institution holding companies and modified LCR companies is approximately \$100 billion in the aggregate, an amount that can be met through changing the mix of their funding profile to more stable funding sources such as stable retail deposits, terming out their liabilities, reducing contingent liabilities (such as commitments), or increasing their holdings of HQLA. With these various options and given the transition period built into the draft final rule, which initially subjects covered companies to a minimum LCR of 80 percent and increases by 10 percent annually, the impact on those institutions subject to the LCR or modified LCR and on the broader economy should be limited.

CONCLUSION: Based on the foregoing, staff recommends that the Board approve the attached draft final rule. In addition, staff also recommends that the Board develop a new proposal for public comment to treat highly liquid municipal securities as HQLA for purposes of the LCR requirement. Staff also recommends that the Board delegate to staff the authority to make technical and minor changes to the attached materials in order to respond to comments from the Federal Register, or to incorporate changes requested by other agencies as part of the approval process.

Attachment

APPENDIX

Overview of Comments on the NPR

The Board received 96 discrete comments and 23 form letters on the NPR. Commenters included banking organizations, trade associations, consumer advocacy groups, public officials (including members of the U.S. Congress and state and local governments), private individuals, and other interested parties.

General comments:

While most commenters supported the creation of standardized minimum liquidity requirements and efforts to improve the resilience of the banking system, many commenters expressed concerns about various aspects of the proposals. A substantial number of commenters requested significant revisions to the proposals, discussed below. Many commenters also asked for additional time to transition to the new requirements.

Applicability and timing:

Commenters argued that the proposed threshold for application of the full LCR inappropriately captures several large regional banking organizations even though the business models, operations and funding profiles of these organizations are more similar to those organizations that would be subject to the modified LCR, rather than the largest banking organizations, which would be subject to the full LCR. Commenters instead suggested that these regional banking organizations be subject to the modified LCR.

Commenters argued that the accelerated timeline would present operational difficulties because covered companies would be required to make comprehensive changes to their information technology systems and that they are facing competing demands for resources to meet other regulatory requirements. Several commenters requested that the implementation date of the rule be delayed, while others requested that the compliance timeline set forth in the Basel III liquidity framework be used so as to minimize the likelihood of an adverse impact on the financial markets.

Calculation of the LCR:

Many commenters expressed concern about the proposed calculation of the LCR under the NPR, stating that the peak day methodology, together with the conservative assumptions regarding the timing of inflows and outflows as well as the outflow rates, overstates liquidity risk and will result in trapped liquidity. Commenters also stated that the peak day measurement would be unduly punitive for banking organizations that have substantial amounts of non-maturity deposits, and will result in the conversion of a 30 calendar-day stress metric into a one-day stress metric.

Commenters requested that the LCR calculation be based on a calendar month stress period, rather than the 30 calendar-day stress period in the proposal. Other commenters requested that the modified LCR be based on a 30 calendar-day period rather than 21 calendar days. Commenters also expressed concern about the significant operational burdens that the daily calculation requirement imposes on financial institutions and stated that a daily calculation was not necessary for regional banking organizations.

Inclusion of assets as high-quality liquid assets (HQLA):

Many commenters disagreed with the criteria proposed to determine which assets may be included by a covered company as HQLA. Commenters requested that the liquid and readily marketable standard be removed or in the alternative that the agencies provide a list of securities that would meet the standard. In addition, commenters requested that certain assets be included as HQLA to cover liquidity needs, such as unused borrowing commitments from Federal Home Loan Banks, tax-exempt money market fund shares, private label mortgage backed securities, covered bonds, or asset backed securities. Commenters also requested that the equities that may be included as level 2B liquid assets be expanded to include equities beyond those included in the Standard & Poor's 500 index.

In addition to requesting the inclusion of certain assets as HQLA, commenters also requested that other assets, such as securities issued or guaranteed by government-sponsored enterprises be given more favorable treatment, arguing that these assets exhibit liquidity characteristics that are similar to the assets that receive the more favorable treatment under the proposed rule. Commenters also requested the inclusion of state and municipal securities as

HQLA, arguing that these asset classes would be eligible as HQLA under the Basel III liquidity framework and that the markets for these securities are sufficiently deep and active to warrant inclusion.

Commenters expressed concern that the requirement that HQLA be held at subsidiaries that are covered insured depository institutions would result in duplicative liquidity that would be trapped at that subsidiary, and cause inflated balance sheets.

Calculation of HQLA:

Several commenters expressed concern about the requirement that secured borrowing and lending transactions that mature within the 30 calendar-day period be unwound as part of the calculation of the covered company's HQLA amount. Commenters stated that this calculation would add to the operational complexity of the rule. Commenters also argued that the inclusion of secured deposits from states and municipalities in the calculation of the diversification requirements was not appropriate and that they as well as collateralized corporate trust deposits and repurchase transaction sweep deposits, should be excluded.

Determining maturity:

Commenters stated that the proposed rule's requirement that covered companies assume that outflows occur on the earliest possible date was overly conservative, unrealistic, and differed from the Basel III liquidity framework. Commenters also expressed concern with the requirement that the covered companies assume that they do not exercise legal notice periods, with several commenters requesting different treatment of notice periods for wholesale and retail counterparties such that covered companies can consider the exercise of the notice period in determining the maturity date for wholesale counterparty-related outflows, such as operational deposits. Other commenters requested that covered companies not be required to assume to have exercised call options or rights to redeem its own debt on wholesale funding instruments and long-term debt issued by the covered company.

Treatment of cash outflows:

Many commenters argued that some of the definitions in the proposed rule, such as brokered deposit, prime brokerage services, and operational deposit, were too broad and would include transactions or deposits that were deserving of more favorable outflow rates. Numerous

commenters requested more favorable treatment for various categories of cash outflows. Several commenters indicated that the treatment of facilities with characteristics of both credit and liquidity facilities as liquidity facilities was overly conservative and inconsistent with the Basel III liquidity framework and with market conventions. A number of commenters addressed the treatment of commitments to special purpose entities, expressing concern that the proposed outflow rate for undrawn commitments to all special purpose entities was too high and unduly punitive and requested that it be lowered. Commenters also stated that the proposed rule's treatment of undrawn commitments to finance commercial real estate would be inconsistent with the industry's practice relating to such facilities, stating that significant operational conditions must be met to draw upon the facility.

Treatment of cash inflows:

Commenters noted an inconsistency between the definition of secured lending transaction in the definitions section of the proposed rule and the treatment of those transactions in the inflow section and requested clarification. Commenters also requested that certain transactions be included as inflows, such as commitments with Federal Home Loan Banks, mortgage commitments, or inflows arising from demand loans and open maturity obligations. Finally, commenters requested that certain inflows, such as deposits by nonbank financial companies supervised by the Board, held at commercial banks, be excluded from the 75 percent inflow cap.