BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Date:	October 18, 2013
To:	Board of Governors
From:	Staff[1]
Subject:	Notice of Proposed Rulemaking – Implementation of Minimum Liquidity Standards

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ACTIONS REQUESTED: Staff seeks the Board's approval of the attached draft notice of proposed rulemaking (NPR or proposal) that would introduce quantitative liquidity requirements for large domestic bank holding companies, savings and loan holding companies,[2] and depository institutions as well as nonbank financial companies designated by the Financial Stability Oversight Council for Board supervision (designated companies) with a comment period of approximately 90 days. Depository institution holding companies and designated companies with substantial insurance operations and savings and loan holding companies with substantial commercial operations (exempted companies) would not be subject to the proposal.[3] The proposal is an enhanced liquidity requirement for bank holding companies and designated companies that are subject to section 165 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act).[4]

The NPR would establish a liquidity coverage ratio (LCR) requirement based on the Basel Committee on Banking Supervision (BCBS)'s liquidity coverage ratio standard for internationally active depository institutions and depository institution holding companies, as well as their depository institution subsidiaries that exceed $10 billion in total consolidated assets (internationally active covered banking organizations).[5] The proposed LCR would also apply to

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[1] Messrs. Gibson, Van Der Weide, Emmel, and Willis and Mmes. Hewko, Aiken, and McKeehan (Division of Banking Supervision and Regulation) and Mr. Alvarez and Mmes. Snyder and Stewart (Legal Division).

[2] Bank holding companies and savings and loan holding companies are collectively referred to herein as "depository institution holding companies."

[3] References to "covered companies" "large covered banking organizations" "savings and loan holding companies," and "designated companies" hereafter do not include exempted companies.

[4] *See* 12 U.S.C. 5365.

[5] Consistent with the regulatory capital rules, internationally active banking organizations are those with consolidated total assets of $250 billion or more or consolidated total on-balance sheet foreign exposure of $10 billion or more.

all designated companies (together with internationally active covered banking organizations, covered companies). In addition, the NPR would establish a modified version of the liquidity coverage ratio (modified LCR) for depository institution holding companies with total consolidated assets of $50 billion or more that are not internationally active.[6] The NPR would be proposed and published in the *Federal Register* jointly with the Federal Deposit Insurance Corporation (FDIC), and the Office of the Comptroller of the Currency (OCC) (collectively, agencies) after each agency has completed its internal review and approval procedures. Staff also requests authority to make technical and minor changes to the attached NPR prior to publication in the *Federal Register* in order to respond to comments from the *Federal Register* or to incorporate changes requested by the agencies as part of the approval process.

DISCUSSION: The recent financial crisis demonstrated significant weaknesses in liquidity risk management by banking organizations and other financial institutions, many of which experienced difficulty meeting their obligations due to a breakdown in funding markets. Prior to the crisis, funding was readily available at low cost. However, market conditions reversed rapidly, putting the financial system under severe stress. As a result, many governments and central banks across the world provided unprecedented levels of liquidity support to financial companies in an effort to sustain the global financial system.

To address these weaknesses in banking organizations' liquidity risk management practices,[7] the BCBS issued new international liquidity standards as part of the December 2010 agreement on capital and liquidity known as "Basel III". The new Basel III standards include a liquidity coverage ratio (Basel III LCR) that is 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 high quality liquid assets sufficient to survive an acute stress scenario that lasts 30 days, which would give time for corrective actions to be taken by company management and supervisors, or allow the triggering of orderly resolution processes. This measure should therefore reduce the likelihood that a large, complex company would require immediate assistance when facing an acute liquidity stress scenario – whether systemic

[6] *See* 12 U.S.C. 5365.

[7] *See* "Basel III: International framework for liquidity risk measurement, standards and monitoring" (December 2010), available at http://www.bis.org/publ/bcbs188.pdf (Basel III Liquidity Framework).

or idiosyncratic – which should also reduce the risk that liquidity shocks in the financial sector significantly affect the entire economy. The Basel III liquidity standards also includes a Net Stable Funding Ratio (NSFR) that is designed to promote resilience over a one-year time horizon by creating additional incentives for banking organizations and other financial companies that would be subject to the standard to fund their activities with more stable sources and encouraging a sustainable maturity structure of assets and liabilities. Currently, the NSFR is in an international observation period as the Board works with other BCBS members and the banking industry to gather data and study the impact of the proposed NSFR standard on the banking system. Board staff anticipates recommending a proposed NSFR rule well in advance of the 2018 global implementation date.

The proposed LCR, based on the Basel III LCR, builds upon and standardizes liquidity coverage methodologies that long have been used by banking organizations to assess exposures to contingent liquidity events. It also complements principles the BCBS has issued for sound liquidity risk management, which the agencies have incorporated into their supervisory guidance.[8] In addition, the proposed LCR would be an enhanced prudential standard that would complement the more qualitative liquidity requirements that the Board has proposed in order to implement under section 165 of the Dodd-Frank Act[9] (section 165 proposal), by providing a standardized metric of short-term liquidity risk in addition to the provisions that companies perform their own liquidity stress tests in the section 165 proposal.

Consistent with the scope of application for the BCBS standards, the NPR would apply the LCR to internationally active covered banking organizations. In addition, the proposal would apply the LCR to designated companies because of their systemic importance and role in the financial system.

Section 165 of the Dodd-Frank Act provides that the Board may tailor application of the enhanced prudential standards for categories of companies, taking into consideration their complexity, size, and other factors.[10] Accordingly, the proposal would apply a modified LCR to

[8] 75 FR 13656 (March 22, 2010).

[9] *See* "Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies," 77 FR 594 (Jan. 5, 2012).

[10] *See* 12 U.S.C. 5365(a)(2).

depository institution holding companies with total consolidated assets of $50 billion or more that are not internationally active (modified LCR companies), which generally are smaller and have less complex liquidity funding structures than covered companies. These firms are neither exposed to the same level of liquidity risks, nor engaged in activities of the same systemic nature; 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 modified LCR is designed to reflect these characteristics by using a 21-day rather than a 30-day liquidity stress scenario on modified LCR companies. At the same time, the modified LCR, as a standardized liquidity metric, would help ensure the liquidity resilience in times of stress of modified LCR companies and also provide a uniform cross-firm basis of comparison of liquidity risk.

Because the liquidity requirements were not designed to reflect the liquidity risk profiles of insurance or commercial activities, the proposal would not apply to companies that are significantly engaged in these activities. Consistent with the Board's recent final regulatory capital rule, exempted savings and loan holding companies with significant commercial activities would not be subject to the proposal pending implementation of a rule regarding intermediate holding companies.[11]

The following summary highlights key aspects of the proposal.

A. <u>Minimum Quantitative Liquidity Requirements and Transition Periods</u>

- **General requirement:** All covered companies and modified LCR companies would be required to continuously maintain a minimum liquidity coverage ratio of 100 percent (minimum LCR requirement). The liquidity coverage ratio would be calculated by dividing a company's high quality liquid assets (the LCR numerator) by its total net cash outflow amount (the LCR denominator) over the relevant period, which is 30 days for covered companies and 21 days for modified LCR companies, as

[11] Under section 626 of the Dodd-Frank Act, the Board may require a grandfathered unitary savings and loan holding company (as defined under the Home Owners' Loan Act (12 U.S.C. 1461 et seq.)) to establish and conduct all or a portion of its financial activities in or through an intermediate holding company and the intermediate holding company itself becomes subject to Board supervision and regulation. *See* section 626 of the Dodd-Frank Act (12 U.S.C. 1467b).

measured by a standard stress scenario that assigns specific outflow and inflow amounts to different categories of funding.

- **Shortfalls in the ratio:** Consistent with Basel III, the proposal would allow a company to convert its high quality liquid assets into cash as necessary to meet unforeseen liquidity needs arising from idiosyncratic and systemic stress events. Because of the myriad of liquidity stresses that a covered company or modified LCR company may experience, the proposal would give supervisors flexibility in responding to instances in which a company's liquidity coverage ratio falls below the minimum LCR requirement. In addition, the proposal would require a covered company and modified LCR company to submit a plan to its primary Federal regulator on how it would achieve compliance with the proposed requirements if its liquidity coverage ratio remains below 100 percent for three consecutive business days or longer, or if the supervisor otherwise determines the firm to be materially noncompliant with the proposal.

- **Transition periods:** The NPR proposes a transition period for implementation of the proposal to mitigate the burden of compliance and potential adverse impact upon the lending or financial intermediation of covered companies and modified LCR companies. On January 1, 2015, covered companies and modified LCR companies would be required to meet a liquidity coverage ratio of 80 percent, increasing annually by 10 percentage-point increments until January 1, 2017, at which point covered companies and modified LCR companies would be required to meet a liquidity coverage ratio of 100 percent. These transition provisions are shorter than those provided for in the Basel III LCR (which begin with a ratio of 60 percent in 2015 and increase annually by 10 percentage points until January 1, 2019). Staff is recommending a shorter transition period to reflect and reinforce the significant improvement of liquidity positions of financial institutions in the U.S. since the financial crisis through supervisory and other efforts.

B. <u>LCR Numerator</u> - <u>High Quality Liquid Assets (HQLA)</u>

In order for an asset to qualify as HQLA, it must be liquid and readily marketable, a reliable source of funding in repo or sales markets, and not an obligation of a financial company.[12] HQLA are divided into three categories based on the nature of the asset and the issuer. The HQLA categories are:

- **Level 1 liquid assets** are the highest quality and most liquid assets and include (1) excess reserves held at the Federal Reserve; (2) withdrawable reserves held at a foreign central bank; (3) securities issued by, or guaranteed by the full faith and credit of, the U.S. government; and (4) certain securities that are claims on, or claims guaranteed by, a sovereign entity, a central bank, and other international entities that are assigned a 0 percent risk weight[13] under the standardized approach of the revised regulatory capital rules. Level 1 liquid assets may be included in the HQLA amount without limit due to their consistently highly liquid nature.

- **Level 2A liquid assets** include claims on, or claims guaranteed by, a U.S. government sponsored enterprise (GSE)[14] and claims on, or claims guaranteed by, a sovereign entity or a multilateral development bank that are assigned a 20 percent risk weight under the standardized approach of the revised regulatory capital rules. Although securities issued and guaranteed by GSEs have historically been highly liquid even in times of stress, their obligations are not as liquid as U.S. Treasuries, and consequently staff recommends that they not be included in level 1 liquid assets. Level 2A liquid assets generally demonstrate a high level of liquidity, but due to their characteristics, may be at higher risk for liquidity impediments than level 1 liquid assets. They therefore would be subject to a 15 percent haircut under the proposal and may only comprise 40 percent of total HQLA when combined with level 2B liquid assets.

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[12] The proposal would not permit HQLA to include securities issued by regulated financial companies (defined to include banking organizations, broker-dealers, insurance companies, and other companies subject to prudential regulation, as well as their consolidated subsidiaries, and, in the case of a depository institution holding company, companies included in the top-tier holding company's organizational hierarchy on the National Information Center website; mutual funds, investment advisers, hedge funds, private equity funds, pension funds, and any company the Board determines should be treated the same as the foregoing companies based on similar activities.

[13] This generally would include all OECD sovereign debt unless the debt was in default or restructured consistent with the revised capital rule (*see* 78 Federal Register 62018 (October 11, 2013).

[14] GSEs include the Federal Home Loan Mortgage Corporation, the Federal National Mortgage Association, the Farm Credit System, and the Federal Home Loan Banks (FHLBs). Capacity to borrow from the FHLBs is not included in HQLA.

- **Level 2B liquid assets** generally include: (1) investment-grade, publicly-traded corporate debt securities; and (2) publicly-traded equities that are included in the Standard & Poor's 500 Index or an equivalent index that meets the satisfaction of the relevant supervisor. Because these securities are subject to significantly higher risk of loss of liquidity due to idiosyncratic or market-wide factors, they would be subject to a 50 percent haircut and could only comprise 15 percent of total HQLA.

In addition, a company cannot include in its consolidated HQLA amount any qualifying assets held by its subsidiaries in excess of the amount of the net cash outflows of the subsidiaries, unless the assets can be transferred to the company without statutory, regulatory, supervisory, or contractual restrictions.

C. LCR Denominator - Total Net Cash Outflow Amount

Under the proposal, total net cash outflow amount would include the difference between a company's total stressed cash outflow and inflow amounts, which would be calculated by applying standard rates based on a 30- or 21-day liquidity stress scenario, as applicable, to the balances of the company's funding sources. The proposal's outflow and inflow rates are designed to distinguish stable funding sources (such as retail deposits) from those that are more volatile (such as financial institution deposits).

Covered companies (but not modified LCR companies) would be required to hold HQLA against their largest net cumulative cash outflow day within a 30-day liquidity stress period, rather than the net cumulative cash outflow as of the end of the period. The provision would require a covered company to identify contractual cash outflows and inflows within the 30-day period and determine which day within the 30-day period results in the greatest net cumulative contractual cash outflow (peak net outflow day). The company would then determine total cumulative net cash outflows by summing this net cumulative contractual cash outflow and cash outflows that do not have a maturity date. On each day following the peak net outflow day, inflows would be sufficient to cover remaining net outflows through the end of the 30-day liquidity stress period. This provision would make the proposed LCR more stringent than the Basel III LCR because it would calibrate net cash outflows to the most severe day within the 30-day liquidity stress period as opposed to the 30^{th} day of the stress period. Staff believes this provision is necessary to account for the potential that cash outflows could occur significantly before cash inflows within a 30-day liquidity stress period, and therefore recommends its incorporation into the proposal.

1. *Total stressed cash outflows*

The proposed outflow rates are intended to approximate severe liquidity stress and, therefore, would vary depending on the funding source. These outflow rates are consistent with the Basel III LCR, which were developed taking into account supervisory experience and observation from the recent financial crisis. The LCR's proposed outflow categories and corresponding outflow rates include the following (outflow rates for the modified LCR would be 70 percent of the LCR's outflow rates):

- <u>Unsecured retail funding.</u> This category generally includes deposits from individuals and small businesses, and would range from 3 percent for stable retail deposits that are fully FDIC-insured to 40 percent for uninsured retail brokered sweep deposits. Generally, retail depositors have been less likely to withdraw their deposits during periods of liquidity stress than other customers and therefore their deposits would be assigned lower outflow rates.

- <u>Unsecured wholesale funding</u>: This category includes most sources of unsecured funding from customers and counterparties that are not individuals or small businesses. Due to the more volatile nature of this funding, the proposed outflow rates would range from 25 percent for certain operational deposits (where a banking organization provides services that require its customers to maintain certain deposit balances with the banking organization, making the deposit more stable) to 100 percent for commercial paper or non-operational deposits from financial entities whose securities cannot be included in HQLA. Generally, unsecured, uninsured wholesale corporate deposits not provided by financial sector entities would be assigned a 40 percent outflow rate.

- <u>Secured, short-term funding</u>: The proposed outflow rates for secured short-term funding would increase progressively reflecting the liquidity characteristics of the collateral. Secured funding backed by level 1 liquid assets would be assigned an outflow rate of zero, secured funding backed by level 2A liquid assets would be assigned a 15 percent outflow rate, and secured funding backed by level 2B liquid assets would be assigned a 50 percent outflow rate. Secured funding backed by non-HQLA would be assigned a 100 percent outflow rate.

- Commitments: The proposal includes a low outflow rate (5 percent) for retail credit facilities, because retail customers are less likely than wholesale customers to draw on the facilities in times of liquidity stress. Outflow rates on most corporate credit facilities would not exceed 40 percent and liquidity facilities to non-bank financial institutions would receive an outflow rate of 100 percent. Outflow rates on credit or liquidity facilities to banks would be 50 percent.

- Federal Reserve Borrowings: Under the proposal, Federal Reserve borrowing of any kind generally is treated the same as other secured wholesale borrowings. Borrowings that are due to the Federal Reserve within 30 days are assumed not to be renewed, are included in net outflows, and assigned an outflow rate that reflect the liquidity characteristics of the collateral, consistent with the outflow rates assigned to secured short-term funding, as described above. Furthermore, the capacity to borrow from the Federal Reserve is not included in HQLA.

2. *Total stressed cash inflows.*

Consistent with Basel III, the proposal would permit a covered company or modified LCR company to offset its total stressed cash outflows with stressed cash inflows, up to 75 percent of its total stressed cash outflows. This limit is meant to prevent a company from exclusively relying on cash inflows to meet the proposal's minimum LCR requirements, rather than maintaining a portfolio of HQLA. Stressed cash inflows include contractual inflows, including interest payments, from outstanding exposures that are fully performing. Akin to the proposed outflow rates, the proposal's inflow rates are meant to reflect a stressed liquidity scenario and maintain an assumption of continued lending to certain counterparties.

CONCLUSION: Staff recommends that the Board approve the attached NPR for comment. Staff also recommends that the Board delegate to staff the authority to make technical and minor changes to the attached materials prior to publication in the *Federal Register*, including responding to comments from the *Federal Register*, or to incorporate technical and minor changes requested by other agencies as part of the approval process. The other agencies are expected to consider and approve seeking comment on this proposal at or about the same time as the Board considers this matter.