Federal Banking Agencies Take First Steps to Implement the Basel III Quantitative Liquidity Regime in the United States

"Super-equivalent" Liquidity Coverage Ratio proposed for the largest U.S. banking institutions; a less-stringent "modified" LCR would apply to other significant bank holding companies

One result of the financial crisis of 2008 was a greater awareness of the importance of liquidity for the stability of large financial institutions, based on the widely accepted conventional wisdom that the crisis was in large part a crisis of liquidity, rather than capital. In response, the international regulatory community began work to develop a quantitative liquidity regulatory framework, culminating in the introduction in 2010 of the Basel III international liquidity framework.[1] In October 2013, the federal banking agencies took their first step towards introducing the Basel III quantitative liquidity regime in the United States through a notice of proposed rulemaking that would impose a minimum LCR requirement on certain banking and non-banking financial institutions (the "LCR Proposal").[2] Although the LCR Proposal largely follows the 2013 Basel III LCR, it would be stricter in several respects, featuring a faster implementation timeline, a narrower definition of "high-quality" liquid assets ("HQLA"), and a more complicated method for calculating net cash outflows designed to address potential maturity mismatches.

Under the LCR Proposal, the largest, most systemically important U.S. financial institutions would be required to maintain sufficient HQLA to meet their maximum one-day cumulative projected net cash outflows during a 30-day stress period. Smaller U.S. banking institutions not subject to the LCR Proposal's full 30-day ratio but that have $50 billion or more in consolidated assets would be subject to a "modified" LCR requirement based on a 21-day stress period, with somewhat simplified calculation methodologies.

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1 See Basel Committee on Banking Supervision (the "Basel Committee"), Basel III: International Framework for Liquidity Risk Measurement, Standards and Monitoring (Dec. 2010) (the "Basel III Liquidity Release"). The Basel Committee subsequently published a revised, final version of the first part of that framework, the liquidity coverage ratio ("LCR"), in January 2013. See Basel Committee, Basel III: The Liquidity Coverage Ratio and Liquidity Risk Monitoring Tools (Jan. 2013) (the "Basel III LCR").

2 See, e.g., Board of Governors of the Federal Reserve System (the "Federal Reserve"), Liquidity Coverage Ratio: Liquidity Risk Measurement, Standards, and Monitoring (Oct. 24, 2013), www.federalreserve.gov/FR_notice_lcr_20131024.pdf. The Office of the Comptroller of the Currency (the "OCC") and the Federal Deposit Insurance Corporation (the "FDIC" and, together with the Federal Reserve and OCC, the "Agencies") each approved their own, substantively identical, versions of the LCR Proposal on October 30, 2013. As of the date of this memorandum, the LCR Proposal had not yet been published in the Federal Register.

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The LCR Proposal is only one of a number of U.S. and international initiatives intended to address liquidity issues at financial institutions. Agency staff are working with the Basel Committee to develop the second portion of the Basel III liquidity framework—the net stable funding ratio ("NSFR")—which would evaluate the stability of a banking organization's funding over a one-year time horizon.[3] Furthermore, the Federal Reserve has expressed concerns that the LCR and NSFR are by themselves insufficient to address the financial stability risks associated with short-term wholesale funding and the related potential for liquidity runs and destabilizing asset fire sales.[4] When Federal Reserve staff presented the LCR Proposal for approval to the Board of Governors, both staff and governors noted that the Federal Reserve is exploring other ways to address these risks.

Although liquidity has been the subject of intense scrutiny at the supervisory level for some time, quantitative liquidity regulation is a novel task for banking regulators, with high stakes in terms of addressing potential risks and the possibility of unforeseen consequences. With additional rules under consideration, implementation efforts yet to begin and international divergences in phase-in of the LCR, financial institutions can expect liquidity to remain a subject of regulatory focus and continued controversy for years to come.

This memorandum identifies the key considerations and areas of controversy raised by the LCR Proposal and provides a side-by-side comparison of the LCR Proposal's requirements as compared to the Basel III LCR. Comments on the LCR Proposal are due by January 31, 2014.

I. Key Considerations

- *Accelerated Transition Period.* The transition period under the LCR Proposal is significantly shorter than the transition period under the Basel III framework, requiring full compliance with the LCR by January 2017, two years before full compliance will be required under Basel III. Agency staff noted that the shorter transition period is intended to "reflect and reinforce" the improved liquidity positions of covered financial institutions since the financial crisis, and the preamble of the LCR Proposal notes that covered institutions with LCRs already at or near the 100% minimum should not view the transition period as an opportunity to reduce their liquidity coverage.

[3] See Staff Memo to the Federal Reserve, Notice of Proposed Rulemaking – Implementation of Minimum Liquidity Standards, at 3 (Oct. 18, 2013), www.federalreserve.gov/aboutthefed/boardmeetings/board-memo-lcr-20131024.pdf; Basel III Liquidity Release.

[4] See, e.g., "The Fire-Sales Problem and Securities Financing Transactions", Speech by Federal Reserve Governor Jeremy C. Stein, Nov. 7, 2013, www.federalreserve.gov/newsevents/speech/stein20131107a.htm; "Evaluating Progress in Regulatory Reforms to Promote Financial Stability", Speech by Federal Reserve Governor Daniel K. Tarullo, May 3, 2013, www.federalreserve.gov/newsevents/speech/tarullo20130503a.htm.

- *"Super-equivalence" to Basel III.* The LCR Proposal is more stringent than the Basel III LCR in a number of other respects, including a narrower definition of HQLA and no tolerance for maturity mismatches. Federal Reserve Governor Tarullo made a point of emphasizing this fact, referring to the LCR Proposal as "super-equivalent" to the Basel III LCR.

- *Additional Liquidity Rules Expected.* Although guidance on liquidity management has been previously issued by the Agencies, the LCR Proposal is the first step towards implementing a broader quantitative liquidity framework. The Agencies are working with the Basel Committee to gather data on the NSFR and expect to complete an NSFR proposal well in advance of the Basel III NSFR implementation date of 2018. The Federal Reserve has emphasized that the LCR and NSFR are mainly "microprudential" supervisory tools; it is also considering other expressly "macroprudential" regulatory measures to address the perceived risks of short-term wholesale funding, which could include further changes to bank liquidity and capital regimes and/or mandatory margin or haircut requirements on securities financing transactions.

- *Connection to Internal Liquidity Stress Testing.* Federal Reserve staff has suggested that the LCR Proposal complements the enhanced prudential supervision regime under Section 165 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"), and in particular the liquidity stress testing and liquidity buffer requirements in the proposed regulations to implement Section 165.[5] In practice, the LCR may simply serve as a supervisory floor underneath the liquidity buffers covered institutions will be required to calculate and hold based on each institution's internal stress tests under the Proposed 165 Rules.

- *Interplay with the Supplementary Leverage Ratio.* The Agencies' recent supplementary leverage ratio ("SLR") proposal has raised concerns that the SLR, rather than risk-based capital calculations, could become the binding capital constraint for some institutions.[6] If it does, then efforts to accumulate larger stocks of HQLA for liquidity buffer purposes could be penalized with higher capital requirements under the non-risk-based SLR. Balancing the incentives

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[5] See 77 Fed. Reg. 76628 (Dec. 28, 2012) (foreign banking organizations); 77 Fed. Reg. 594 (Jan. 5, 2012) (domestic banking organizations) (the "Proposed 165 Rules")

[6] See 78 Fed. Reg. 51101 (Aug. 20, 2013). The SLR proposal would effectively require the eight U.S. bank holding companies ("BHCs") (and their subsidiary banks) that have been identified as global systemically important banks ("G-SIBs") to hold an additional 2% (parent-level) and 3% (bank-level) Tier 1 capital buffer on top of the 3% SLR applicable under the U.S. rules implementing the Basel III capital framework.

between these two regulations may prove challenging for institutions and their regulators.

- *Interplay with Other Regulatory Collateralization Requirements*. The LCR Proposal is only one of a number of regulatory reforms that are expected to increase demand for high-quality assets such as U.S. treasury bonds over the next few years. Regulators have been studying the potential for a shortage of HQLA that could be caused by the combination of higher liquidity requirements and increased demand for collateral and margin from clearing organizations and OTC swap counterparties.[7] Other jurisdictions faced with potential HQLA supply shortfalls have sought to develop alternative methods to satisfy the HQLA requirement with, for example, contractually committed central bank liquidity facilities, as contemplated in the Basel III LCR.

- *Financial Companies' Securities Excluded from HQLA.* Both the Basel III LCR and the LCR Proposal exclude all securities issued by financial institutions from the definition of HQLA, regardless of their liquidity or risk profile. The rationale for the exclusion is the potential for "wrong-way" risk in a financial distress situation, when there would be greater likelihood for such assets' value to deteriorate significantly.

- *Narrower HQLA Definition.* The LCR Proposal sets forth a more conservative definition of HQLA than the Basel III LCR. In particular, it excludes residential mortgage-backed securities ("RMBS") and covered bonds from HQLA, and allocates U.S. government sponsored entity ("GSE") MBS to Level 2A, despite their historic record as an asset class with high liquidity and marketability during times of stress. The LCR Proposal contains no explicit analysis of the potential implications of this exclusion for housing finance or its interplay with GSE reform.

- *Exclusion of Municipal Securities from HQLA*. Securities issued by states, municipalities and other non-sovereign public sector entities would be excluded from HQLA despite their 20% risk weighting under the Agencies' capital rules. The LCR Proposal explains that the Agencies believe that such securities are not sufficiently liquid and marketable in U.S. markets.

- *Cross-border Holdings of HQLA*. The LCR Proposal expresses a number of concerns regarding overseas holdings of HQLA, but it would not impose a general quantitative limit on the ability of a covered institution to count HQLA held in another jurisdiction or currency. It would, however, require certain categories of assets to be used to meet outflows in their same jurisdiction and currency in

[7] See, e.g., Committee on the Global Financial System, Bank of International Settlements, Asset Encumbrance, Financial Reform and the Demand for Collateral Assets (May 2013), www.bis.org/publ/cgfs49.pdf.

order to count as HQLA.[8] The LCR Proposal also mandates that covered institutions have policies and procedures to ensure that overseas holdings of HQLA are "appropriate" with respect to the institution's outflows in the relevant jurisdictions and it generally expects covered institutions "to maintain in the United States an amount and type of HQLA sufficient to meet its total net cash outflow in the United States".

- *Implications for Section 165 HQLA Definition*. The LCR Proposal's definition of HQLA is broader in scope than the definition in the much earlier Proposed 165 Rules, which suggests that the Federal Reserve may use such definition when it finalizes the Proposed 165 Rules.[9]

- *Treatment of Term and Brokered Retail Deposits*. The LCR Proposal diverges from the Basel III LCR in its calculation of cash outflows from term and brokered retail deposits.[10]

  - The LCR Proposal purposefully does not differentiate between retail non-brokered deposits that have a contractual term within the 30-day stress period and such deposits that do not have a contractual maturity or have a contractual maturity outside the 30-day stress period. As such, the calculations of cash outflows are not differentiated based on maturity for non-brokered retail deposits.

  - Brokered deposits would be divided into three basic categories—deposits from reciprocal deposit placement networks, deposits from sweep accounts, and other brokered deposits—each of which receives significantly worse treatment under the LCR Proposal's outflow assumptions than other retail deposits. The baseline assumption for brokered deposits is a 100% cash outflow for deposits with no term or a term maturing within the 30-day stress period. Reciprocal and sweep

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8 In particular, certain foreign sovereign securities with a non-0% risk weight would only be includable in level 1 HQLA if the sovereign entity issues the securities in its own currency and the securities are held to meet cash outflows in the jurisdiction of the sovereign entity, and common stock issued in a currency other than dollars could only be included as level 2B HQLA to the extent it offsets cash outflows in that jurisdiction.

9 The Proposed 165 Rules define "highly liquid assets" to include only cash and securities issued or guaranteed by the U.S. government, a U.S. government agency, or a GSE, but allow covered companies to demonstrate to the Federal Reserve that other assets should be included, such as "plain vanilla" corporate bonds. The LCR Proposal's definition of HQLA is limited to a predefined set of asset classes that is significantly broader than the preapproved highly liquid assets under the Proposed 165 Rules, and includes certain claims on sovereigns, investment-grade corporate debt, and certain common equity shares. See Table A below.

10 See Table B below for a comparison of outflow assumptions between the Basel III LCR and the LCR Proposal.

deposits get somewhat better treatment, depending on whether they are fully insured by the FDIC and/or come from an affiliated entity.

- *Partially FDIC-Insured Deposits*. Fully FDIC-insured retail deposits are eligible for better outflow rates under the LCR Proposal, subject to certain conditions, but the LCR Proposal would not apply the lower outflow rate applicable to deposits fully insured by the FDIC to deposits that are only partially insured by the FDIC. Therefore, if any part of a retail deposit is not FDIC-insured, the whole of the retail deposit would become ineligible for the favorable rate. This is a departure from the Basel III LCR, which would only make the uninsured portion of retail deposits ineligible for a lower rate.

- *Effect of Deposit Insurance*. The LCR Proposal would not give credit for deposit insurance provided from foreign jurisdictions. Citing the variability in deposit insurance systems, the Agencies indicated that they were waiting for international standards to develop, and were soliciting comment on how to treat differing foreign insurance schemes.

- *Timing of Outflows and Inflows*. The LCR Proposal requires a covered institution to use the "most conservative" assumptions regarding when an inflow or outflow would occur. In other words, for instruments or transactions with no maturity dates, or variable maturity dates, the institution must assume the earliest possible date for outflows and the latest possible date for inflows, taking into account any explicit or embedded options that could modify maturity dates. This assumption is likely to draw significant criticism, especially as applied to no-maturity outflows and inflows, where outflows with indeterminate maturity dates are assumed to occur on day one, while inflows without maturity dates are assumed not to materialize.

- *Secured Funding from Federal Reserve Banks*. The LCR Proposal requires covered companies to make the same outflow assumptions with respect to secured funding arrangements with Federal Reserve Banks as with secured funding arrangements with all other counterparties, on the theory that funding arrangements with Federal Reserve Banks are not automatically rolled over. This implies that the Agencies do not want to encourage dependence on Federal Reserve Bank borrowing, notwithstanding the Federal Reserve's role as lender of last resort particularly in times of stress.

- *Effective Minimum LCR*. Although the LCR Proposal permits covered institutions to offset outflows with inflows maturing on or before the date of the outflows, in the aggregate inflows cannot offset more than 75% of the covered institution's total net cash outflow amount, creating an HQLA "floor" equal to 25% of the institution's cash outflows.

- *Application to the U.S. Operations of Foreign Banking Organizations*. The LCR Proposal does not apply to branches and agencies of foreign banking organizations ("FBOs"). The OCC stated it would continue to monitor regulatory developments before applying these requirements to federal branches and agencies. The LCR Proposal does not address the treatment of the intermediate holding companies ("IHCs") that certain FBOs may be required to form under the Proposed 165 Rules. If the Federal Reserve determines to apply the LCR Proposal to an IHC, it could reduce the liquidity available to satisfy the parent FBO's home country LCR.

- *Harmonization with Other Jurisdictions' Liquidity Regimes.* The implementation of the Basel III LCR in other jurisdictions could differ in important respects from the LCR Proposal. If other jurisdictions choose to adopt a more flexible version of the Basel III LCR, U.S. institutions may be put at a competitive disadvantage compared to peer institutions domiciled abroad.

- *Reporting and Disclosure Issues.* While the LCR Proposal requires that the LCR be calculated on a daily basis, it does not address reporting or disclosure. The Agencies noted that they anticipate seeking comment on regulatory reporting and public disclosure requirements separately. At that time, the Agencies will presumably need to address the potential implications that public disclosure of an institution's LCR could have for markets and the stability of covered institutions.

II. Covered Institutions

Under the LCR Proposal, the following institutions would be subject to the full 30-day LCR requirement ("covered institutions"):

- "Internationally active banking organizations" with (i) $250 billion or more in total global assets or (ii) $10 billion or more in on-balance sheet foreign exposure;[11]

- Any consolidated subsidiary depository institution of such internationally active banking organizations, if the depository institution has $10 billion or more in total consolidated assets; and

- Non-bank financial companies designated by the Financial Stability Oversight Council under Section 113 of Dodd-Frank for supervision by the Federal Reserve ("Non-bank SIFIs").

[11] These generally include BHCs and savings and loan holding companies ("SLHCs") that are subject to the Agencies' advanced approaches risk-based capital rules. See 78 Fed. Reg. 62018 (Oct. 11, 2013).

BHCs and SLHCs with $50 billion or more in total consolidated assets that do not fall into one of the three categories above would be required to comply with the modified 21-day LCR requirement on a consolidated basis, but their depository institution subsidiaries are not subject to a separate LCR requirement. In addition, BHCs and Non-bank SIFIs with significant insurance activities, and "grandfathered" SLHCs whose assets or revenues are primarily commercial, would not be subject to the LCR Proposal.[12] The Federal Reserve has indicated that it intends to separately consider how best to tailor liquidity rules to these institutions' business models.

III. Effective Dates

The LCR Proposal's transition period is significantly shorter than the transition period proposed for the Basel III LCR, as shown in the table below. Federal Reserve staff indicated that the accelerated timeline reflects their desire to preserve the significantly improved liquidity position of covered institutions since the financial crisis. The Federal Reserve estimates that covered institutions already hold 90% of the approximately $2 trillion in HQLA that would be required if the LCR Proposal were in effect today.

Transition Periods

	January 1, 2015	**January 1, 2016**	**January 1, 2017**	**January 1, 2018**	**January 1, 2019**
LCR Proposal	80%	90%	100%	100%	100%
Basel III	60%	70%	80%	90%	100%

IV. LCR Formula

Under the LCR Proposal, a covered institution would be required to calculate its LCR on a daily basis, as of a set time each day selected by the institution (which time cannot be changed without supervisory approval). The numerator of the LCR calculation would equal the amount of HQLA held by the institution. The denominator of the LCR would consist of the "total net cash outflow amount" as calculated based on both contractually maturing outflows and inflows as well as the LCR Proposal's fixed assumptions for stressed outflows and inflows. The calculation of the numerator and denominator are described in the following sections.

[12] The LCR Proposal specifically exempts top-tier BHCs, SLHCs and Non-bank SIFIs that are insurance underwriting companies or that hold 25% or more of their total consolidated assets in subsidiaries that are insurance underwriting companies (excluding, in each case, assets associated with insurance for credit risk). Grandfathered unitary SLHCs that derive 50% or more of their consolidated assets or total revenues from commercial activities are also exempt. The Federal Reserve has also deferred application of capital rules to these institutions in order to develop an appropriate capital scheme applicable to them.

$$LCR = \frac{\text{HQLA amount as of the calculation date}}{\text{Total net cash outflow amount as of the calculation date}} \geq 100\%$$

a. High-Quality Liquid Assets

Consistent with the Basel III LCR, the LCR Proposal classifies HQLA into level 1, level 2A and level 2B assets. An unlimited amount of level 1 assets may be counted towards a covered institution's HQLA, but only a portion of a covered institution's HQLA may be level 2A and level 2B assets as set forth below. In addition, level 2A and 2B assets are subject to haircuts in the calculation of HQLA. Table A in the appendix summarizes the classes of assets includable in level 1, level 2A and level 2B under the LCR Proposal and under the Basel III LCR framework, and the haircuts associated with each.

Level 1 Assets	Up to 100% of HQLA
Level 2A Assets	Up to 40% of total HQLA, in aggregate with Level 2B assets
Level 2B Assets	Up to 15% of total HQLA

When calculating HQLA levels, Basel III requires covered institutions to assume the unwinding of all secured funding transactions, secured lending transactions, asset exchanges and collateralized derivatives transactions that mature within the 30-day stress period if HQLA are exchanged in such transactions (e.g., a securities borrowing where level 1 assets collateralize a short-term loan of level 2B assets). The unwinding is intended to prevent covered institutions from using such short-term asset exchanges to inflate their level 1 HQLA. The LCR Proposal, unlike the Basel III LCR, requires covered institutions to calculate HQLA both with and without unwinding, and to use the lower resulting HQLA figure in the numerator of the LCR.

To be eligible as HQLA, assets must satisfy a number of operational and other criteria in addition to the criteria needed to qualify for a specific asset category.

- Securities issued or guaranteed by financial companies, broadly defined, are excluded from HQLA.[13]

[13] For this purpose, financial companies would include "regulated financial companies" (BHCs and SLHCs; Non-bank SIFIs; depository institutions; foreign banks; credit unions; industrial loan companies, industrial banks, or other similar institutions; national banks, state member banks, or state nonmember banks that are not depository institutions; insurance companies; securities holding companies; registered broker-dealers; futures commission merchants and swap dealers; security-based swap dealers; designated financial market utilities; foreign

- Most securities—other than central bank reserves and U.S. government securities—must be "liquid and readily-marketable" to qualify as HQLA.[14]
  - Certain asset classes—including corporate bonds and equity shares, and certain shares of sovereigns and central banks—must also be demonstrated to "have a proven record as a reliable source of liquidity . . . during stressed market conditions" through historical evidence of the extent of the asset class's price declines during a 30-day period of significant stress.
- Assets included in HQLA must be unencumbered and cannot be (i) client pool assets held in a segregated account or cash received from secured funding transactions involving segregated client pool securities, (ii) assets received, or generated from assets received, under a rehypothecation right if the beneficial owner could withdraw the asset without remuneration at any time during the 30-day stress period or (iii) designated to cover operational costs.
- Assets held in U.S. and non-U.S. consolidated subsidiaries of a covered institution can be included in the HQLA calculation up to (i) the amount of net cash outflows attributed to the subsidiary plus (ii) additional amounts of assets that would be available for transfer to the covered institution without statutory, regulatory, contractual or supervisory restriction during times of stress.[15] For HQLA held outside of the United States, covered institutions must have policies and procedures to ensure that the holdings are "appropriate" with respect to the institution's outflows in relevant jurisdictions and are "generally expected" to maintain sufficient HQLA in the United States to meet their U.S. outflows.
- The covered institution must be able to demonstrate its operational capability to monetize its HQLA during a stress period by:

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companies if they are supervised and regulated in a manner similar to the institutions listed above; any company included on the organizational chart of a depository institution holding company filed on Form FR Y-6, even if not consolidated under applicable accounting standards); investment companies; non-regulated funds (e.g., private equity and hedge funds); pension funds; investment advisers; or a consolidated subsidiary of any of the foregoing.

[14] "Liquid and readily-marketable" securities are those traded in high volume in active secondary markets characterized by more than two committed market makers, a large number of other participants and timely and observable market prices.

[15] For example, regulatory restrictions on transactions with affiliates under the Federal Reserve's Regulation W, supervisory restrictions on dividend payments, or subsidiary-level liquidity buffer requirements, all could prevent a subsidiary's HQLA from counting at the level of its parent. In the case of assets held outside of the United States, other jurisdictions may have different liquidity buffer requirements that could restrict the flow of HQLA.

   - implementing and maintaining policies, procedures and systems to monetize HQLA and to determine the composition and amount of HQLA on a daily basis, including, assets' location; and

   - periodically monetizing a representative sample of HQLA.

- HQLA must be placed under the control of the management function responsible for managing a covered institution's liquidity risk, which must demonstrate its control over the HQLA by:

   - segregating the HQLA from other assets; or

   - demonstrating its ability to monetize the assets without conflicts with risk or business management strategies.

- Covered institutions must reflect the effect of terminating specific transactions hedging HQLA in their net cash outflow calculation (because liquidation of the HQLA would require close out of the offsetting hedge).

- Covered institutions must determine and track the composition of their HQLA buffers on a daily basis (including, e.g., legal entity holding the HQLA; type of assets, counterparties, issuers, etc.; currency; geographic location and jurisdiction).

b. Total Net Cash Outflows

One of the most significant divergences between the LCR Proposal and Basel III is the manner in which the LCR Proposal requires total net cash outflows to be calculated. Whereas Basel III measures cash outflows as the total net outflows and inflows through the entire 30-day stress period, the LCR Proposal would require a covered institution to calculate its cumulative net cash outflow for each day in the 30-day window (e.g., by summing the inflows and outflows for that day and each preceding day), and to use the highest net cash outflow day out of the 30-day window as the denominator for the LCR calculation.[16] This change is intended to address maturity mismatches that could otherwise arise within the 30-day window, by preventing a covered institution from offsetting an earlier arising outflow with a later arriving inflow (e.g., a principal payment owed to a covered institution on a loan coming due on the 25th day could not be counted against an obligation of the bank to make a payment on outstanding

[16] The Federal Reserve proposed a similar methodology for an intermediate holding company to calculate intercompany cash flow needs in the Proposed 165 Rules for FBOs. See 77 Fed. Reg. 76628, 76686 (Dec. 28, 2012). This approach was not used in the earlier Proposed 165 Rules applicable only to domestic bank holding companies, see 77 Fed. Reg. 594 (Jan. 5, 2012), and may represent an evolution in thinking on the part of the Federal Reserve that will carry over to other liquidity regulations.

debt coming due on the 15th day). Companies subject to the modified 21-day LCR would not be required to use this "worst-day" scenario, but instead could simply net inflows and outflows throughout their 21-day stress period, simplifying the LCR calculation considerably.

As mentioned above, the LCR Proposal adopts a "conservative" methodology for determining the timing of outflows. Covered institutions are required to assume instruments and obligations mature at the earliest possible maturity date for purposes of making outflow calculations, and must assume that any explicit or embedded options are exercised on the earliest possible date. Conversely, institutions must use the latest possible maturity date, and assume options are exercised at the latest possible day for purposes of making inflow calculations. As a result, the calculation methodology effectively assumes demand deposits and committed credit and liquidity facilities are drawn on day one of the 30-day stress period, and therefore cannot be offset with inflows coming later in the 30-day period.

i. Cash Outflow Assumptions

All outflows maturing within the 30-day stress period would be included in the calculation of total outflows, although depending on the category, regulatory outflow rates may include some assumed rollover of maturing obligations. In addition, certain categories of instruments and transactions without maturity dates—such as retail deposits and committed credit and liquidity facilities—have assigned outflow rates, as do certain instruments that mature outside of the 30-day window (e.g., term retail deposits and brokered deposits).

Table B in the appendix reflects the outflow rates that the LCR Proposal has set for various funding sources when calculating the cash outflows that factor into the denominator of the LCR and the modified LCR. To calculate the outflows associated with each funding source, a covered institution must multiply the total value of funding from each source by the applicable outflow rate. The sum of these individual outflow amounts yields the covered institution's total outflows.

As reflected in the table, the outflow rates applicable to the modified LCR for outflow categories without contractual maturity dates are only 70% of the rates of the unmodified LCR, because the modified LCR is based on a shorter 21-day stress scenario, rather than the full 30-day scenario. For outflow categories with contractual maturities, the modified LCR's outflow rates are equivalent to the outflow rates applicable to the unmodified LCR, assuming the maturity date is within the 21-day stress period for the applicable obligation.

ii. Cash Inflows

The calculation of cash inflows under the LCR Proposal is generally consistent with the Basel III approach. Under the LCR Proposal, and consistent with the Basel III framework, total stressed cash inflows can only offset a maximum of 75% of total cash outflows, on the theory that a covered institution should not rely exclusively on expected cash inflows to

satisfy its projected cash outflows under the LCR. In addition, a covered institution cannot "double-count" assets by counting them as HQLA in the numerator and including them as cash inflows in the denominator.

Only cash flows that mature within the 30-day stress period can be included as inflows in the calculation of total net cash outflows—cash flows without stated maturities and contingent cash inflows such as credit and liquidity facilities are entirely excluded from the calculation. The inflow rates under Basel III and the LCR Proposal for different categories of instruments and transactions are reflected in Table C in the appendix.

V. Consequences of an LCR Shortfall

Because a rigid approach to enforcement of the LCR could undercut the LCR's ultimate purpose—providing a liquidity buffer that is available for use in times of stress—the LCR Proposal does not prescribe specific penalties or remedial actions for institutions that have an LCR shortfall. Instead, it requires a covered institution to notify its primary federal supervisor on any day in which it has, or will have, an LCR shortfall. If the shortfall continues for three consecutive business days, the covered institution would be required to present a liquidity remediation plan to its primary federal supervisor, which would be required to include: (i) an assessment of the covered institution's liquidity position, (ii) actions taken and to be taken to achieve compliance with the LCR, (iii) an estimated time frame for compliance, and (iv) a commitment to report to the supervisors at least weekly on the progress towards achieving compliance. Other supervisory or enforcement actions for failure to comply with the LCR would be left to the discretion of a covered institution's primary regulator.

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If you have any questions, please feel free to contact Derek Bush, Katherine Carroll, Hugh Conroy, Patrick Fuller or any of your regular contacts at the firm. You may also contact our partners and counsel listed under "Banking and Financial Institutions" located in the "Practices" section of our website at http://www.cgsh.com/.

Appendix

Table A: Summary of Components of HQLA[17]

U.S. Proposal		Basel III	
Level 1 Assets	**Includable at:**	**Level 1 Assets**	**Includable at:**
• Federal Reserve Bank balances • Foreign central bank reserves, withdrawable without restriction • Securities issued or guaranteed by the U.S. Department of Treasury and other U.S. government agency securities backed by the full faith and credit of the U.S. government • Certain claims on or guaranteed by sovereigns, central banks or multilateral development banks (“MDBs”) with a 0% risk weight • Claims on non-0% risk-weighted sovereigns if issued in sovereign’s own currency and used to meet outflows in sovereign’s jurisdiction	100%	• Coins and bank notes • Qualifying central bank reserves • Qualifying marketable securities from sovereigns, central banks, public sector entities (“PSEs”), and MDBs with a 0% risk weight • Non-0% risk weighted sovereign or central bank debt (i) issued in domestic currency in which liquidity risk is taken or the bank’s own country or (ii) issued in a foreign currency and used to meet outflows in that currency stemming from the bank’s operations in the jurisdiction where the bank’s liquidity risk is being taken	100%
Level 2A Assets		**Level 2A Assets**	
• Investment grade claims on or guaranteed by U.S. government sponsored enterprises (“GSEs”) if senior to preferred stock • Certain claims issued or guaranteed by a sovereign entity or multilateral development bank not included in level 1 assets and with risk weights not exceeding 20%	85%	• Qualifying sovereign, central bank, multilateral development banks, and PSE assets qualifying for 20% risk weighting • Qualifying corporate debt securities rated AA- or higher • Qualifying covered bonds rated AA- or higher	85%
Level 2B Assets		**Level 2B Assets**	
• Certain investment-grade publicly traded corporate debt securities • Certain publicly traded common equity shares included in the S&P 500 or an equivalently liquid index	50%	• Qualifying RMBS • Qualifying corporate debt securities rated between A+ and BBB- • Qualifying common equity shares	75% 50% 50%

[17] Certain asset classes are subject to additional conditions not listed on this table.

Table B: Outflow Assumptions

Category	Proposal LCR outflow amount	Modified LCR outflow amount	Basel III LCR outflow amount	Description
Unsecured retail funding				
Stable retail deposits	3%	2.1%	3%	This category includes all unsecured non-brokered retail deposits of both individuals and certain small businesses. • The LCR Proposal applies a 3% rate to stable deposits that are entirely covered by FDIC insurance, the lowest allowable rate for insured deposits under Basel III. However, stable deposits do not include deposits covered by foreign deposit insurance schemes, despite their eligibility for designation as stable deposits under Basel III. • Deposits that are uninsured or only partially covered by FDIC insurance, or insured by deposit insurance of another jurisdiction, receive the 10% rate for both the insured and uninsured portions. • Under the LCR Proposal, outflow rates do not distinguish between demand and term deposits, even when a term deposit matures outside of the 30-day window. Basel III's default treatment would have excluded term deposits maturing outside the 30-day window from outflows if there was either no legal right to withdraw the deposit within 30 days or if withdrawal would result in significant penalties. • Basel III does not address non-deposit retail funding.
Other retail deposits	10%	7%	5-10%	
Other unsecured retail funding	100%	70%	N/A	
Retail Brokered Deposits				
Brokered deposits that mature later than 30 calendar days from the calculation date	10%	7%	0%	This category includes all deposits obtained through the mediation or assistance of a deposit broker. • The LCR Proposal considers brokered deposits a more volatile funding source than non-brokered retail deposits, and therefore applies higher rates to these deposits. • Basel III does not distinguish between brokered and non-brokered deposits, but permits national regulators to develop additional buckets of retail
Reciprocal brokered deposits, entirely covered by deposit insurance	10%	7%	3%	
Reciprocal brokered deposits, not entirely covered by deposit insurance	25%	17.5%	5-10%	

Category	Proposal LCR outflow amount	Modified LCR outflow amount	Basel III LCR outflow amount	Description
Brokered sweep deposits, issued by a covered institution or an affiliate, entirely covered by deposit insurance	10%	7%	3%	deposits with higher run-off rates as they deem necessary. • Reciprocal brokered deposits and brokered sweep deposits are treated more favorably than other brokered deposits because of the established relationships between the covered companies and the depositors involved, which the Agencies reason are more stable than other brokered deposits. • Reciprocal brokered deposits are defined as deposits received through a deposit placement network on a reciprocal basis (e.g., so that each institution is placing deposits as agent with others in the network). • Sweep deposits are deposits from securities firms or investment companies that sweep idle customer funds into deposit accounts at one or more banks.
Brokered sweep deposits, not issued by a covered institution or an affiliate, entirely covered by deposit insurance	25%	17.5%	3%	
Brokered sweep deposits, not issued by a covered institution or an affiliate and not entirely covered by deposit insurance	40%	28%	5-10%	
All other retail brokered deposits	100%	70%	3-10%	
Unsecured wholesale funding				
Non-operational, entirely covered by deposit insurance	20%	14%	20%	This category includes unsecured wholesale funding (such as wholesale deposits, federal funds purchased, unsecured advances from a public sector entity, and unsecured notes and bonds), and operational deposits (deposits that customers are required to maintain in connection with services provided by the covered institution such as clearing or cash management). • Basel III includes lower rates for small business deposits (5% for insured deposits, 10% if uninsured). The LCR Proposal addresses small business deposits by classifying certain small business deposits as retail deposits. • For other (non-small business) wholesale funding categories, the LCR Proposal assigns the lowest rates allowable under Basel III. • Prime brokerage deposits and correspondent banking arrangements are not included in the definition of operational deposits; therefore, these deposits receive a 100% rate.
Non-operational, not entirely covered by deposit insurance	40%	28%	40%	
Non-operational, from financial company or consolidated subsidiary	100%	70%	100%	
Operational deposit, entirely covered by deposit insurance	5%	3.5%	5%	
Operational deposit, not entirely covered by deposit insurance	25%	17.5%	5% (Insured Portion) 25% (Remainder)	
All other wholesale funding	100%	70%	100%	

<table>
<tr><th>Category</th><th>Proposal LCR outflow amount</th><th>Modified LCR outflow amount</th><th>Basel III LCR outflow amount</th><th>Description</th></tr>
<tr><td colspan="5">Commitments</td></tr>
<tr><td>Undrawn credit and liquidity facilities to retail customers</td><td>5%</td><td>3.5%</td><td>5%</td><td rowspan="7">This category includes the undrawn portion of committed credit facilities (which provide general funds, including working capital funds) and committed liquidity facilities (which provide funds expressly for refinancing debt where a counterparty is unable to obtain a primary or anticipated source of funding).
• The LCR Proposal applies a 50% rate to undrawn credit and liquidity facilities committed to banks and BHCs, whereas Basel III allows for rates as low as 40% for facilities committed to these entities.
• The LCR Proposal applies the lowest rates proposed under Basel III for all other defined categories in this group.
• Covered institutions may reduce outflow rates associated with undrawn facilities where those facilities are secured by level 1 or level 2A HQLAs, if the covered institution has not included such collateral in calculating its stock of HQLAs for purposes of the LCR.</td></tr>
<tr><td>Undrawn credit facility to wholesale customers</td><td>10%</td><td>7%</td><td>10%</td></tr>
<tr><td>Undrawn liquidity facility to wholesale customers</td><td>30%</td><td>21%</td><td>30%</td></tr>
<tr><td>Undrawn credit and liquidity facilities to certain banking organizations</td><td>50%</td><td>35%</td><td>40%</td></tr>
<tr><td>Undrawn credit facility to financial companies</td><td>40%</td><td>28%</td><td>40%</td></tr>
<tr><td>Undrawn liquidity facility to financial companies</td><td>100%</td><td>70%</td><td>100%</td></tr>
<tr><td>Undrawn liquidity facilities to SPEs or any other entity</td><td>100%</td><td>70%</td><td>100%</td></tr>
<tr><td colspan="5">Structured Transactions</td></tr>
<tr><td>Sponsored structured transactions of both consolidated and unconsolidated issuing entities</td><td>See description</td><td>See description; calculated for 21 days or less from the calculation date (instead of 30 days)</td><td>Matches the LCR Proposal</td><td>This category includes all structured transactions sponsored by a covered institution. Outflow amounts for such transactions are the greater of:
• 100% of the amount of all debt obligations of and all asset purchase commitments made by the issuing entity that mature within 30 days or less from the calculation date; and
• The maximum contractual amount of funding the covered institution may be required to provide to the issuing entity within 30 days or less from the calculation date through a liquidity facility, a return or repurchase of assets from the issuing entity or under another a funding agreement.</td></tr>
</table>

Category	Proposal LCR outflow amount	Modified LCR outflow amount	Basel III LCR outflow amount	Description
Derivatives				
Net derivative cash outflows	100%	See description; calculated for 21 days or less from the calculation date (instead of 30 days)	100%	This category includes the payments and collateral that a covered institution must make or deliver to derivatives counterparties within 30 days of the calculation date. • If a qualifying master netting agreement exists, outflows may be reduced by payments and collateral due to the covered institution within 30 days.
Mortgages				
Mortgage commitments	10%	See description; calculated for 21 day stress period (instead of 30 days)	N/A	This category includes a covered entity's contractual commitments to fund its own origination of retail mortgages that can be drawn upon within a 30-day stress period. • Basel III does not directly address outflows related to mortgage commitments.
Collateral Outflows				
Collateral required to be posted due to contractual downgrade triggers linked to changes in covered institution's financial condition	100% (maximum possible under contract)	Follows unmodified LCR Rate	100% (assumes 3-notch credit downgrade)	This category requires covered companies to recognize outflows related to changes in collateral requirements securing derivatives and other financing transactions for both the covered institution and its counterparties that are likely to arise during a financial crisis. • The LCR Proposal generally follows the Basel III framework. One notable exception is the treatment of changes in a covered institution's financial condition: the Basel III framework assumes additional outflows based upon a 3-notch downgrade of the bank's long-term credit rating, while the LCR Proposal would require a covered institution to include all additional amounts of collateral that it could be required to post as a result of a change in financial condition • In addition to specific potential contractual collateral demands or flows, both Basel III and the LCR Proposal include a generic "derivative
Potential collateral demands caused by changes in value of collateral posted by covered institution	20% of fair value of non-level 1 collateral posted by the covered institution	Follows unmodified LCR Rate	20% of non-level 1 collateral posted by the covered institution	
Return of excess collateral posted by counterparties	100% of fair value of collateral that exceeds contractual requirement	Follows unmodified LCR Rate	100% of collateral that exceeds contractual requirement	
Contractually-required collateral, not yet posted	100%	100%	100%	

Category	Proposal LCR outflow amount	Modified LCR outflow amount	Basel III LCR outflow amount	Description
Collateral substitution by counterparty (replacing higher quality collateral with lesser collateral)	Varies depending on quality of collateral counterparty substitutes	Follows unmodified LCR Rate	100% of amount of HQLA collateral that can be substituted for non-HQLA by a counterparty	collateral change" measurement designed to capture the risk of collateral calls caused by asset price fluctuations in the institution's aggregate derivatives book.
Derivative collateral change	Largest net collateral outflow or inflow over 30 consecutive days within 24 month look-back period	Largest net collateral outflow or inflow over 21 consecutive days within 24 month look-back period	Largest net collateral outflow or inflow over 30 consecutive days within 24 month look-back period	
Debt Securities Market Making				
Structured debt securities issued by the covered institution	5%	Follows unmodified LCR Rate	N/A	This category includes all of a covered institution's own debt securities with maturities outside of a 30-day stress period for which the covered institution serves as the primary market maker. • This category is left to the discretion of national regulators by Basel III. • Outflows calculated under this category are in addition to any outflows from securities maturing within the 30-day stress period.
All other debt securities issued by the covered institution	3%	Follows unmodified LCR Rate	N/A	
Secured Funding and Asset Exchange				
Maturing secured funding transactions collateralized by:				This category includes: (i) maturing secured funding transactions that may require cash outflows or additional or higher quality collateral to support a given level of secured debt; and (ii) contractually required non-cash asset exchanges that may cause covered companies to exchange high quality assets for lower quality assets. • The rules apply different outflow rates to different transactions and exchanges based on the quality of the assets (e.g., level 1, level 2A or level 2B) that secure the debt or that are to be exchanged. • Secured funding transactions with sovereigns, MDBs, and U.S. GSEs receive favorable 25% rate when not
• Level 1 assets	0%		0%	
• Level 2A assets	15%		15%	
• Level 2B assets				
o Eligible RMBS	N/A		25%	
o Other Level 2B assets	50%		50%	
• Non-HQLA assets	100%		100%	

Category	Proposal LCR outflow amount	Modified LCR outflow amount	Basel III LCR outflow amount	Description
• Funds from customer short positions that are collateralized by other customers' non-HQLA collateral	50%		50%	secured by level 1 or level 2A assets as opposed to 50% rate applicable to other transactions secured by level 2B assets. • Collateral lent to a customer to effect the customer's short position is treated as secured funding. • Basel III does not specifically address asset exchanges. • Asset exchange rates are based on fair value of assets posted to counterparty as determined under GAAP.
Asset exchanges				
• Level 1 (exchanged for Level 1)	0%		N/A	
• Level 1 (exchanged for Level 2A)	15%		N/A	
• Level 1 (exchanged for Level 2B)	50%		N/A	
• Level 1 (exchanged for non-HQLA)	100%		N/A	
• Level 2A (exchanged for Level 1 or Level 2A)	0%		N/A	
• Level 2A (exchanged for Level 2B)	35%		N/A	
• Level 2A (exchanged for non-HQLA)	85%		N/A	
• Level 2B (exchanged for HQLA)	0%		N/A	
• Level 2B (exchanged for non-HQLA)	50%		N/A	

Category	Proposal LCR outflow amount	Modified LCR outflow amount	Basel III LCR outflow amount	Description
Foreign Central Bank Borrowings				
Covered institution borrowings from foreign central banks	See description	Follows unmodified LCR Rate	Not Addressed	This category includes all of a covered institution's borrowings from foreign central banks. • If a foreign jurisdiction has established an outflow rate for central bank borrowings under a minimum liquidity standard, that outflow rate applies. • Otherwise, the rule controlling outflow rates for Secured Funding applies.
Other contractual outflow amounts				
Applicable contracts not otherwise specified in the LCR Proposal	100%	Follows unmodified LCR Rate	100%	This category includes all contractual payments owed within 30 days or less after a calculation date that are not specified elsewhere in the rules, such as salary payments.

Table C: Inflow Assumptions

Category	Proposal	Basel III	Notes
Items Excluded from Cash Inflows			
Operational deposits (held at other regulated financial companies)	0%	0%	• Proposal and Basel III assume amounts held for operations are unlikely to be available during a stress scenario.
Derivatives that are mortgage commitments (including forward sales of mortgage loans)	0%	N/A	• Divergence from Basel III based on Agencies' repayment expectations from experience in financial crisis. • Does not include derivatives that hedge interest rate risk associated with mortgage pipeline.
Credit or liquidity facilities	0%	0%	• Both the LCR Proposal and Basel III cite interconnectedness as concern from relying on liquidity inflows from other financial institutions.
HQLA and any amount payable with respect to HQLA	0%	0%	• Avoids double counting. • Includes HQLA that mature within 30 days.
Non-performing assets	0%	0%	• Also excludes assets a covered institution "has reason to expect" will become non-performing within the 30-day stress period.
Assets with no contractual maturity	0%	0%	
Other Categories of Inclusions			
Derivatives	100%	100%	• Net inflows against outflows only if derivatives are subject to a qualifying master netting agreement; otherwise gross inflows and outflows. • Valuation consistent with existing valuation methodology. • The LCR Proposal excludes forward sales and derivatives on mortgage loans.
Retail cash inflow amount	50%	50%	• Assumes banks continue to make loans during stress scenario.
Unsecured wholesale cash inflow (with respect to financial companies)	100%	100%	• Inflow assumption based on expectation that covered institution will not continue to extend credit to financial companies during a financial stress scenario.
Unsecured wholesale cash inflow (non-financial)	50%	50%	• As with retail inflows, based on assumption that covered institution will continue to sustain core business lines.
Securities cash inflow	100%	100%	• Cash inflow from payment received on securities that are not included in the covered institution's HQLA, including due and expected

Category	Proposal	Basel III	Notes
			dividends, interest and principal.
Maturing secured lending transactions collateralized by:			• The LCR Proposal specifies that lending must be secured by a lien that grants priority on specifically designated assets owned by the counterparty and included in the covered institution's HQLA. • Maturing reverse repos or securities borrowing agreements secured by Level 1 assets are assumed to rollover without cash inflow. • Maturing reverse repos and secured borrowing agreements secured by non-HQLA assets are assumed not to rollover. • The LCR Proposal and Basel III assume 0% inflow if collateral from margin loans is used to cover short positions.
• Level 1 assets	0%	0%	
• Level 2A assets	15%	15%	
• Level 2B assets			
○ Eligible RMBS	N/A	25%	
○ Other Level 2B assets	50%	50%	
• Non-HQLA assets	100%	100%	
• Collateralized margin loans to customers	50%	50%	
Asset exchange inflow amount (based on assets received):			• Counterparty must be contractually obligated to provide higher-quality in return for less liquid, lower-quality assets. • All rates are applied to fair value of received assets as determined under GAAP.
• Level 1 (exchanged for Level 1 assets)	0%	N/A	
• Level 1 (exchanged for Level 2A)	15%	N/A	
• Level 1 (exchanged for Level 2B)	50%	N/A	
• Level 1 (exchanged for non-HQLA)	100%	N/A	
• Level 2A (exchanged for Level 1 or Level 2A)	0%	N/A	
• Level 2A (exchanged for Level 2B)	35%	N/A	
• Level 2A (exchanged for non-HQLA)	85%	N/A	
• Level 2B (exchanged for HQLA)	0%	N/A	
• Level 2B (exchanged for non-HQLA)	50%	N/A	
Total Cash Inflows			
Total Cash Inflows = lesser of (x) total cash inflows and (y) 75% of total cash outflows			

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