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Alert Memo

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Significant Revisions to Liquidity Coverage Ratio Expected to Reduce Burden on Banking Organizations

On January 7, 2013, the Basel Committee on Banking Supervision (the "BCBS") released highly-anticipated revised rules (the "2013 Rules")[1] governing the Liquidity Coverage Ratio (the "LCR") included in the Basel III framework finalized in December 2010 (the "2010 Proposal").[2] The LCR is intended to improve short-term resilience to liquidity risk by requiring banking organizations to hold high quality liquid assets ("HQLA") that can be quickly and easily monetized to cover their liquidity needs over a 30-day liquidity stress scenario. The LCR requires banking organizations to maintain a ratio of HQLA to "total net cash outflows over the next 30 calendar days" of 100%, except in periods of stress. The 2013 Rules provide important relief to banking organizations by both expanding the definition HQLA (effectively increasing a banking organization's LCR numerator) and reducing the outflow rates that must be applied to certain deposits and liquidity facilities (effectively decreasing its LCR denominator). This memorandum provides a high-level overview of the LCR revisions and their expected impact on banking organizations.

Delayed Implementation. Banking organizations will have more time to comply with the LCR. While the LCR will be introduced as originally proposed on January 1, 2015, banking organizations will not be required to maintain an LCR of 100% until January 1, 2019. The LCR will be phased in gradually, requiring banking organizations initially to maintain an LCR of 60%, increasing annually in 10% increments.

Expanded Definition of HQLA. The 2013 Rules significantly expand the category of "Level 2" assets eligible for inclusion in a banking organization's HQLA. The 2013 Rules subdivide Level 2 assets into Level 2A and Level 2B.

- Level 2A assets include claims on or guaranteed by sovereigns, central banks, public sector entities ("PSEs"), or multilateral development banks and corporate debt (including commercial paper) rated at least AA- (subject to a 15% haircut).

[1] BCBS, Basel III: The Liquidity Coverage Ratio and Liquidity Risk Monitoring Tools (Jan. 2013). Available at: http://www.bis.org/publ/bcbs238.htm.

[2] BCBS, Basel III: International Framework for Liquidity Risk Measurement, Standards and Monitoring. (Dec. 2010). Available at: http://www.bis.org/publ/bcbs188.pdf.

- Level 2B assets include corporate debt securities rated A+ to BBB–, certain unencumbered equities (each subject to a 50% haircut), and certain residential mortgage-backed securities ("RMBS") rated AA or higher (subject to a 25% haircut).

Level 2A assets remain subject to a 15% haircut under the 2013 Rules, and when combined with Level 2B assets cannot represent more than 40% of the overall stock of HQLA. Level 2B assets are subject to a more restrictive quantitative limit of 15% of the overall stock of HQLA. The 2013 Rules clarify that an institution must calculate the 15% cap prior to calculating the 40% cap, and only include in the 40% those Level 2B assets that are permitted under the 15% cap.

Corporate Debt Securities. The 2013 Rules provide that corporate bonds (in notable contrast to RMBS) that are internally rated as having a probability of default corresponding to an investment grade rating will be eligible for inclusion in Level 2 assets subject haircuts. This appears to be an acknowledgment that when the U.S. federal banking agencies implement the Basel liquidity framework in the United States, their proposed rules may not require external credit ratings as a qualification criterion for Level 2 assets, due to the restrictions imposed by Section 939A of the Dodd-Frank Act. Accordingly, it appears that local supervisors will be permitted to implement this aspect of the liquidity framework without expressly requiring an external credit rating. In addition to these ratings requirements, corporate debt securities must satisfy certain additional criteria related to price volatility during stress scenarios.

Equities. Common equity shares must also satisfy additional qualification criteria to be eligible for inclusion as a Level 2B asset under the 2013 Rules. Specifically, equity shares must be exchange traded and centrally cleared and must be a constituent of the major stock index in the home jurisdiction or where the liquidity risk is taken. To qualify for inclusion in HQLA, equity shares also must not have demonstrated a decline of share price exceeding 40% or increase in haircut (in a repo market) exceeding 40 percentage points over a 30-day period during a relevant period of significant liquidity. The 2013 Rules permit a significant amount of price volatility and therefore potential market risk, which appears to differ significantly from the definition of highly liquid assets in the Federal Reserve's proposals to introduce a formal liquidity requirement on U.S. financial institutions deemed "systemically important financial institutions", which would require assets to demonstrate low market risk to be eligible for inclusion in the liquidity buffer.[3]

RMBS rated AA or higher. While this provision when initially announced appeared to include private label RMBS in Level 2 assets,[4] the conditions these securities would be

3 Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies, 77 Fed. Reg. 594 (Jan. 5, 2012); Enhanced Prudential Standards and Early Remediation Requirements for Foreign Banking Organizations and Foreign Nonbank Financial Companies, 77 Fed. Reg. 76,628 (Dec. 28, 2012).

4 BCBS, Complete set of agreed changes to the formulation of the Liquidity Coverage Ratio published in December 2010, (Jan. 7, 2013). Available at: http://www.bis.org/press/p130106b.pdf.

required to satisfy under the 2013 Rules would appear to disqualify most private label securitizations of U.S. mortgages. Specifically, the underlying mortgages of eligible RMBS must be "full recourse'' loans that have a maximum loan-to-value ("LTV") ratio of 80% on average at issuance. This recourse criterion will likely disqualify private label RMBS issued in the United States as many U.S. states require mortgages to be non-recourse, including California. In addition, eligible RMBS must be subject to "risk retention" regulations which require issuers to retain an interest in the assets they securitize. Moreover, securitizations of residential mortgages with a LTV of 80% would likely meet the proposed definition of "qualifying residential mortgage" in the U.S. federal banking agencies' proposed risk retention rule, although finalization of that definition is the subject of significant industry concern. Under the proposed risk retention rule, asset backed securities collateralized by qualifying residential mortgages would be exempt from the risk retention requirement and therefore such RMBS would seem to not qualify for inclusion as Level 2B assets.[5] In implementing the rule in the United States, additional flexibility could be provided if it were determined that such exempt securitizations were, in fact, "subject" to the risk retention regulations, but were exempted because of their quality and therefore should *a fortiori* be included in Level 2B assets.

Additional Operational Requirements. The 2013 Rules expand the operation criteria banking organizations must satisfy in order for their assets to be eligible for inclusion in HQLA. Specifically, banking organizations are directed to exclude from HQLA assets that it does not have the operational capability to monetize to meet outflows during the stress period. To satisfy these operational requirements, banking organizations must demonstrate that they have procedures and appropriate systems in place to execute monetization of any asset at any time. Monetization of the asset must be executable, from an operational perspective, in the standard settlement period for the asset class in the relevant jurisdiction. These operational criteria further require that HQLA remain in control of the function charged with managing the liquidity of the banking organization, meaning the function has the continuous authority, and legal and operational capability, to monetize any asset in the stock. Control must be evidenced either by maintaining assets in a separate pool managed by the function with the sole intent for use as a source of contingent funds, or by demonstrating that the function can monetize the asset at any point in the 30-day stress period and that the proceeds of doing so are available to the function throughout the 30-day stress period without directly conflicting with a stated business or risk management strategy. These separation requirements could require significant restructuring of a banking organization's existing risk management policies and procedures.

Adjustments to Outflow Rates. The 2013 Rules make several significant adjustments to the outflow rates banking organizations must apply to certain categories of

[5] See 76 Fed. Reg. 24090, 24166 (Apr. 29, 2011).

deposits and liquidity facilities which are expected to reduce a banking organization's total net cash outflows, thereby helping to increase its LCR.

Insured Deposits. The 2013 Rules permit national regulators to reduce the outflow rate applicable to certain fully insured retail deposits from 5% to 3% if they are protected by a national deposit insurance. The deposit insurance scheme must be pre-funded via the periodic collection of levees on covered banking organizations and the scheme must have ready access to additional funds in the event of a large call on its reserves. Jurisdictions applying the 3% run-off rate to stable deposits with deposit insurance arrangements that meet the above criteria should be able to provide evidence of run-off rates for stable deposits within the banking system below 3% during any periods of stress experienced that are consistent with the conditions within the LCR. The favorable 3% run-off assumption (and the general 5% run-off assumption for "stable" retail deposits) are only applicable to the portion of retail deposits that are insured, and not to the portion of deposits that exceed the insurance limit.

The 2013 Rules also reduce outflow on fully insured non-operational deposits from non-financial corporates, sovereigns, central banks and public sector entities to 20%. The 2010 Proposal initially applied a 75% run off factor to these deposits. Under the 2013 Rules, such deposits are generally eligible for a 40% run off factor, which is reduced to 20% if the deposits are fully insured. The 2013 Rules also reduce the outflow rate for "non-operational" deposits provided by non-financial corporates, sovereigns, central banks and PSEs from 75% to 40%.

Liquidity Facilities. The 2013 Rules revise the definition of liquidity facilities and significantly reduce the drawdown rate on the unused portion of committed liquidity facilities to non-financial corporates, sovereigns, central banks and PSEs from 100% to 30%. The 2013 Rules define liquidity facility as any committed, undrawn back-up facility that would be utilized to refinance the debt obligations of a customer in situations where such a customer is unable to rollover that debt in financial markets (such as pursuant to asset backed commercial paper programs, secured financing transactions, obligations to redeem units, etc). For the purpose of this standard, the amount of the commitment to be treated as a liquidity facility is the amount of the currently outstanding debt issued by the customer (or proportionate share, if a syndicated facility) maturing within a 30-day period that is backstopped by the facility. The portion of a liquidity facility that is backing debt that does not mature within the 30-day window is excluded from the scope of the definition of a facility. Any additional capacity of the facility would be treated as a committed credit facility. The rules further clarify that general working capital facilities for corporate entities (such as revolving credit facilities in place for general corporate or working capital purposes) will <u>not</u> be classified as liquidity facilities, but as credit facilities. Generally a liquidity facility is assumed to be drawn in greater amounts than credit facilities, although for some counterparties they are treated the same.

The 2013 Rules also distinguish between interbank and inter-financial credit and liquidity facilities and reduce the outflow rate on the former from 100% to 40%. Under the

2013 Rules, committed credit and liquidity facilities extended to banks subject to prudential supervision are assigned a 40% run off rate for the undrawn portion of these facilities. Committed credit facilities to other financial institutions including securities firms, insurance companies, fiduciaries, and beneficiaries also are assigned a 40% run off rate. By contrast, committed liquidity facilities to other financial institutions including securities firms, insurance companies, fiduciaries, and beneficiaries are assigned a 100% run off rate. Generally, however, drawdown rates are assumed to be greater for financial institutions than for non-financial corporates, sovereigns, central banks, PSEs and multilateral development banks (between 10% and 30%). Drawdown rates on committed credit and liquidity facilities to special purpose entities, conduits and other entities are assumed to be 100%.

Implementation of the LCR. The Basel III liquidity framework has yet to be implemented in the United States or Europe. The U.S. federal banking agencies are expected to propose implementing regulations for the LCR in 2013. The European Commission has proposed to implement the Basel III capital and liquidity frameworks through the issuance of a new regulation, the Capital Requirements Regulation (the "CRR"), which is part of the CRD IV package of reforms. Legislative proposals for the CRR will likely need to be revisited to take into account the 2013 Rules and a key question is whether these amendments to the CRR will further delay its implementation.

The Net Stable Funding Ratio ("NSFR"). With the release of the 2013 Rules, the BCBS also indicated that it is currently reviewing the NSFR (the ratio of a banking organization's available amount of stable funding divided by its required amount of stable funding, evaluated over a one-year time horizon). The BCBS also reaffirmed its intention that the NSFR be implemented as a requirement by January 1, 2018.

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