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Basel III Framework: Liquidity Coverage Ratio (US Implementation)

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The three US bank regulatory agencies issued a final regulation implementing the Basel III Liquidity Coverage Ratio (LCR) which requires banking organizations to maintain a minimum amount of liquid assets in order to meet short-term liquidity needs. The LCR is to be phased in over a three-year period beginning in January 2015. In the EU, the LCR standards have already been implemented although further technical details remain to be fleshed out by secondary legislation ahead of January 2015.

The Regulation adopted by the Office of the Comptroller of the Currency ("OCC"), Board of Governors of the Federal Reserve System ("Fed"), and Federal Deposit Insurance Corporation ("FDIC") (collectively the "US Supervisors") is a requirement of Section 165 of the Dodd-Frank Wall Street Reform and Consumer Protection Act. It applies to the largest US banking organizations which are, in general, those with $250 billion or more in consolidated assets and $10 billion or more in foreign exposures. A modified version applies to those US banking organizations with $50 billion or more in consolidated assets.[1] Non-US banking organizations are not covered by the Regulation but are expected to be subject to the similar requirements in the future.

The LCR was developed in response to poor liquidity management within banks that contributed to the financial crisis. It provides for liquidity buffers to be maintained that are sufficient to absorb liquidity needs under stressed conditions. This is a core element of the

[1] The Regulation has not yet been published in the Federal Register. The Regulation is available at http://www.federalreserve.gov/newsevents/press/bcreg/20140903a.htm. The proposals were published at 78 Fed.Reg. 230 (November 29, 2013). The Regulation generally conforms to the analogous international liquidity standard originally published by the Basel Committee on Bank Supervision (the "Basel Committee") in 2010 and revised in 2013, available at http://www.bis.org/publ/bcbs238.htm.

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Basel III framework and is supplemental to a longer term structural ratio (the "Net Stable Funding Ratio")[2]

It must also be viewed in the context of a bank's overall need for high-quality liquid assets (HQLA) which are driven by: collateral quality constraints imposed by clearing houses compounded by tightening collateral eligibility standards; reduced cross-product netting within the cleared environment and the proliferation of segregated portfolios; the Net Stable Funding Ratio (where the "Available State Funding" amount is able to be satisfied by HQLA); margin standards for non-cleared derivative trades (including restrictions on rehypothecation); and a shift towards more secured funding. In due course, reforms applying to the shadow banking sector will add further pressure in terms of collateral valuation standards and minimum haircuts. Some acknowledgment of the step change in the stock of HQLA that will need to be held by banks was reflected in the loosening of the LCR standard by the Basel Committee from its initial proposal compared to the final Basel Committee standards.

In broad terms, the Regulation requires covered banks to maintain an amount of HQLA that exceeds the aggregate of: (1) the amount its projected outflows exceed its projected inflows over a 30-day horizon, with the projected inflows being capped at 75% of the projected outflows; and (2) an add-on based on the difference between the highest net cumulative outflow amount on any day during the 30-day period and the net cumulative outflow amount on day 30 (subject in each case to a floor of zero), but only in respect of items that have a maturity during the 30-day period. The inclusion of an add-on amount goes beyond the Basel III standard and is intended to address the possibility that the unevenness in inflows and outflows over a 30 day period could result in liquidity pressures at certain points in such period which is not reflected in the overall aggregate net outflow figure for the entire period. Entities subject to the modified version of the rule can exclude the add-on and need only hold 0.7 times the amount calculated in (1). It is notable that in this respect the EU implementation of the LCR, by contrast, is more faithful to the Basel standard and therefore less onerous.

Covered banks will have some flexibility in designing policies and procedures to ensure compliance with the Regulation, particularly as to operational requirements. For instance, covered banks will be permitted to determine the appropriate amount of HQLA that may be held by non-US branches and subsidiaries to satisfy liquidity needs at those locations, subject to supervisory review. However, in general, all HQLA will have to be subject to the control of the covered bank's management function responsible for managing liquidity risk and must be available for use to address liquidity needs as they arise in any part of the bank network.

[2] The Net Stable Funding Ratio proposed standards are available at: http://www.bis.org/publ/bcbs271.pdf. Our Client Publication on the proposed standards is available at: http://www.shearman.com/~/media/Files/NewsInsights/Publications/2014/02/BaselIIIFrameworkNetStableFundingRatioProposed-StandardsFIAFR020614.pdf.

The LCR Standard requires the following calculations to be made (a detailed list of the various constituents of the inflow and outflow items are set out in the Appendix):

- Projected inflows (that is, funds to be paid to the bank by third parties) on the basis of either the maturity of the bank's assets or the qualitative nature of the assets, or both, for each of the 30 days following the calculation date.
  - For example, only 50 percent expected from retail customer obligations can count as an inflow, while 100percent of unsecured obligations of financial institutions can be assumed as an inflow.
- Projected outflows (that is, funds to be paid by the bank to third parties) in generally the same manner as inflows but based on the bank's obligations over a 30 day horizon.
  - For example, the total outflow expected from "stable retail deposits" (fully covered by FDIC insurance) is 3 percent of all such deposits and from other retail deposits is 10 percent.
- The largest difference between projected outflows and projected inflows for the ensuing 30 day period is the "net cash outflow amount." This is the amount that has to be covered by HQLA and may be no less than 25 percent of total outflows.[3]

Only certain types of assets are eligible as HQLA, and various categories of assets are subject to "haircuts" reflecting varying degrees of creditworthiness and liquidity. Eligible categories of assets and associated haircuts are as follows:

- Level 1 liquid assets: debt securities issued or fully guaranteed by the Federal Government; Federal Reserve Bank balances above required reserves; and certain sovereign and multilateral development bank debt securities. They are permissible without limit and are not subject to a haircut.
- Level 2A liquid assets: debt securities issued or fully guaranteed by a Federal Government-sponsored enterprise that the bank believes qualify as investment grade or by certain sovereigns and multilateral banks. They are subject to a 15 percent haircut and may total no more than 40 percent of total HQLA, including any assets that qualify as Level 2B assets described below.
- Level 2B liquid assets: certain publicly-issued debt securities issued by non-financial corporates that are categorized as investment grade and have a proven track record as a reliable source of liquidity and certain corporate common equity publicly traded in the S&P 500 Index or Russell 1000 Index. They are subject to a 50 percent haircut and may total no more than 15 percent of total HQLA.[4]

Excluded from these categories are securities issued by any financial institution, defined broadly to include regulated banking and securities companies, registered and private investment funds, pension funds, and consolidated subsidiaries of any of them. In addition, municipal (state and city) debt, covered bonds and apparently mortgage-backed securities are excluded. However, a proposal is under consideration that would make certain highly liquid municipal securities eligible for HQLA. Under the Basel III standard, there is greater recognition of corporate debt securities both as Level 2A assets and residential mortgage-backed securities are included as Level 2B assets subject to a haircut, and securities issued or guaranteed by public sector entities can be included as Level 1 and Level 2A assets.

The timeline for effectiveness of the Regulation is as follows:

[3] The method of calculation is detailed in Subpart C of the Regulation, at Sections __.30 through __.33.

[4] The method of calculation is detailed in Subpart C of the Regulation, at Sections __.20 through __.22.

- The effective date will be January 1, 2015, with a two-year phase-in period whereas Basel III phases in a 100% LCR requirement by 2019. Banks would have to maintain 80 percent of the required HQLA during 2015, 90 percent during 2016, and 100 percent thereafter.
- However, in order to accommodate operational constraints, the daily calculation requirement for banks with $700 billion or more in consolidated assets or $10 trillion or more in custody will begin on July 1, 2015. For other institutions with $250 billion or more in total consolidated assets, daily calculation will begin on July 1, 2016. Prior to these dates, institutions may make calculations on an end-of-month basis.
- Institutions subject to the modified version will be subject to a phase-in by January 1, 2016 and are required to make calculations on an end-of-month basis. They will only need to hold HQLA that covers 70 percent of their total net cash outflows.

The Regulation recognizes that, in certain circumstances, a bank may not have sufficient HQLA to meet the required amount. In any such case, the bank must report the shortfall to its US Supervisor, which may require the bank to submit a plan setting out how compliance will be achieved. If a bank has a shortfall for three consecutive business days, the bank will be obliged promptly to prepare a plan for achieving compliance. Non-compliance can be met with supervisory or enforcement action.

In the EU, rules implementing the LCR (set out in the Capital Requirements Regulation No. 575/2013) are being phased in from January 1, 2015. At that point, a 60% LCR requirement must be achieved by all EU firms subject to the Capital Requirements Regulation. A “super-equivalent” approach by individual EU Member States which goes beyond minimum LCR requirements is permitted. Both the US and the EU rules deviate from Basel III by requiring full LCR implementation ahead of the Basel III deadline of 2019. Under US rules the LCR must be fully implemented by 2017, and under EU rules the LCR must be fully implemented by 2018. However, markets may expect firms to comply with a fully-loaded LCR at an earlier date. The EU LCR rules are substantially final although certain areas remain to be developed by the European Banking Authority which is mandated to set out implementing technical standards (“ITS”) on certain aspects of the LCR. Various ITS are now final although a number of ITS remain to be developed and finalized ahead of January 2015.

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Appendix

TYPE OF CASH OUTFLOW	OUTFLOW RATE
Stable retail deposits § 32(a)	3%
All other retail deposits § 32(a)	10%
Other unsecured retail funding § 32(a)	20 – 40%
Structured transaction outflow § 32(b)	Depends
Net derivative cash outflow amount § 32(c)	Depends
Mortgage commitment outflow amount § 32(d)	10%
Commitment outflow amount § 32(e)	0 – 100%
Collateral outflow amount § 32(f)	20 – 100%
Collateral outflow amount (collateral substitution) § 32(f)	0 – 100%
Retail brokered deposit outflow amount § 32(g)	10 – 100%
Unsecured wholesale funding amount § 32(h)	5 – 100%
Debt security outflow amount § 32(i)	3 – 5%
Secured funding outflow amount § 32(j)	0 – 100%
Foreign central bank borrowings § 32(k)	Depends
Other § 32(l)	0 – 100%

TYPE OF CASH INFLOW	INFLOW RATE
Excluded cash inflows (mortgages, credit/liquidity facilities, & others) § 33(a)	0%
Net derivative cash inflow amount § 33(b)	Depends
Retail cash inflow amount § 33(c)	50%
Unsecured wholesale cash inflow amount § 33(d)	0 – 100%
Securities cash inflow amount § 33(e)	100%
Secured lending cash inflow amount (asset exchange) § 33(f)	0 – 100%
Broker-dealer segregated account inflow amount § 33(g)	0 – 100%
Other cash inflow amounts § 33(g)	0%

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This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

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