MEMORANDUM

TO: Public File - Notice of Public Rulemaking: Liquidity Coverage Ratio: Liquidity Risk Measurement, Standards, and Monitoring, (RIN 3064-AE04) ("Liquidity Coverage Ratio NPR")

FROM: Greg Feder, Counsel, Legal Division

DATE: May 20, 2014

SUBJECT: Meeting with Representatives from The Clearing House and the American Bankers Association

---

On April 14, 2014, FDIC staff, together with staff of the Board of Governors of the Federal Reserve System and the Office of the Comptroller of the Currency, met with representatives of The Clearing House and the American Bankers Association (the "Associations").

Representatives from the Associations presented their concerns and views with regard to certain provisions of the Liquidity Coverage Ratio NPR, which was issued in the Federal Register of November 29, 2013 (78 FR 71818), including the impact of the NPR on prime brokerage operations, as reflected in the attached materials.

The FDIC representatives at this meeting were:

- Kyle Hadley, Section Chief for Examination Support, Capital Markets/RMS
- Eric Schatten, Policy Analyst, Capital Markets/RMS
- Greg Feder, Counsel, Legal Division

The Associations' representatives in attendance at this meeting were:

- Lisa Fitzgerald, JPMorgan Chase
- Gonzalo Martin, Citi
- Igor Modlin, Goldman Sachs
- Andrew Nash, Morgan Stanley
- Joseph Noto, JPMorgan Chase
- Penny Novick, Morgan Stanley
- Dan Park, Morgan Stanley
- Mason Reeves, Bank of America
- Roberto Severino, Santander
- Liz Robinson, Goldman Sachs
- Adeesh Setya, Morgan Stanley
- Alison Touhey, American Bankers Association
- Christopher Van Woeart, Goldman Sachs
- David Wagner, The Clearing House

The following Association representatives participated in the meeting by telephone:

- Peter Abric, Wells Fargo
- Darrell Baber, Wells Fargo
- Michele Bianco, Bank of America
- Hulya Brake, Wells Fargo
- Parijat Cheema, JPMorgan Chase
- Sara Cummings, Bank of America
- Dennis Curtin, Wells Fargo
- Greg Gamble, US Bank
- Nicole Graven, US Bank
- Todd Hodgin, Wells Fargo
- Keith Huebsch, Bank of America
- Kevin Kenny, Bank of America
- Eamon McCooey, Wells Fargo
- Mark McFalls, Wells Fargo
- Peter Mozer, Citi
- Adam Perry, JPMorgan Chase
- Ryan Pozin, The Clearing House
- Eugene Rabinovich, Bank of America
- Stephen Randall, Citi
- Jennifer Scott, The Clearing House
- Brian Smedley, Bank of America
- Matthew Smith, Bank of America
- Erik Soderberg, Morgan Stanley
- Debbie Toennies, JPMorgan Chase
- Andrea Tokheim, Sullivan & Cromwell
- Jason Vecchio, US Bank
- Brett Waxman, The Clearing House
- Scott Weaver, Wells Fargo
- Helen Wu, Wells Fargo
- Jennifer Xi, BNY Mellon
- Yingli Xie, Citi

The Clearing House®
At the Center of Banking Since 1853

Liquidity Coverage Ratio: Prime Brokerage

April 2014

TCH CONFIDENTIAL STAFF DRAFT

Introduction: Key Prime Brokerage LCR Considerations

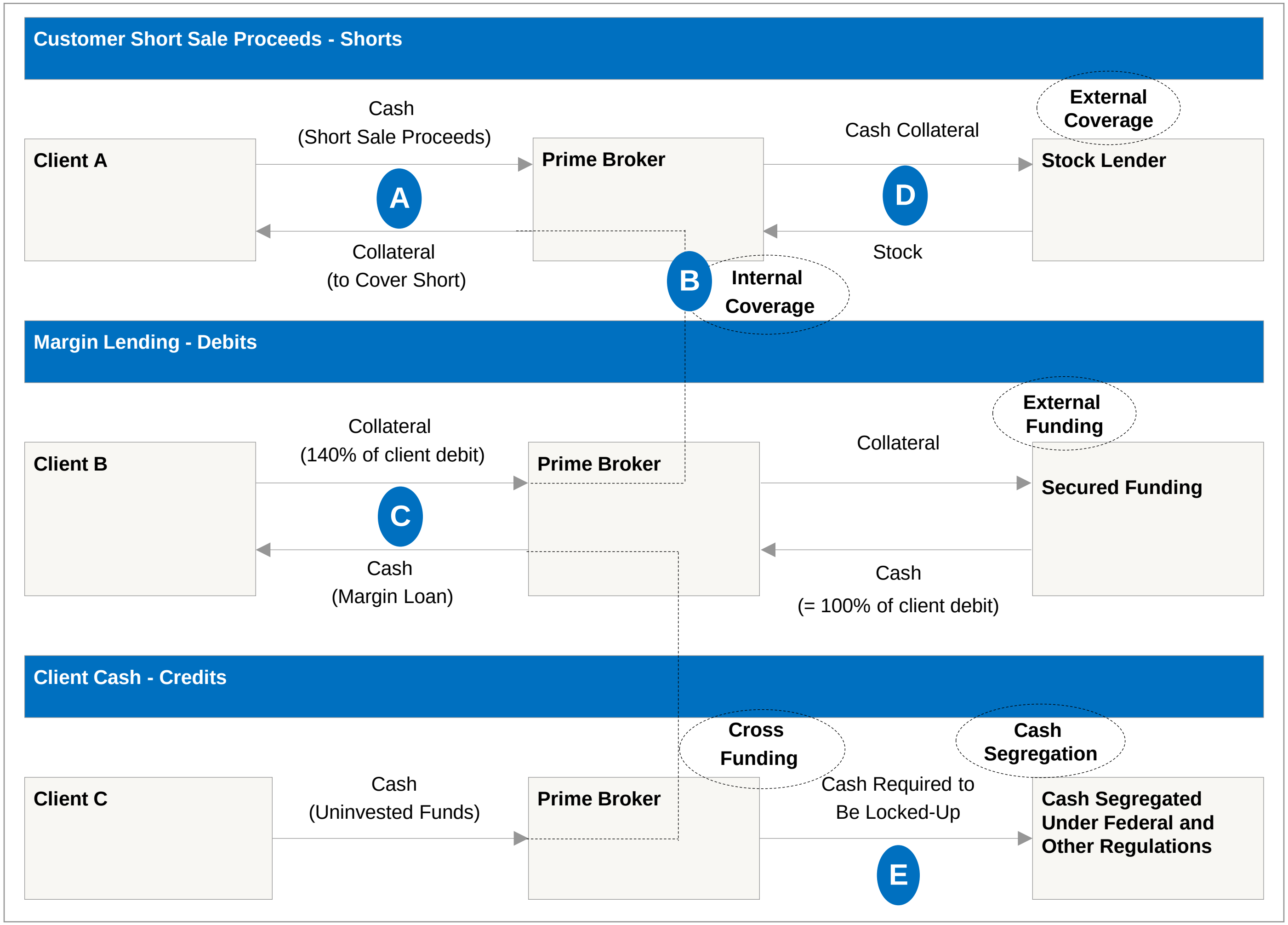
The Liquidity Coverage Ratio prescribes standardized cash inflow and outflow rates that a banking organization must use to calculate its total net cash outflows over the 30-day stress period.

This presentation provides an overview of the following five issues in regards to the Agencies' proposed rulemaking of the Liquidity Coverage Ratio. Our recommendations would be:

1. *Internal Coverage:* The LCR's 50% outflow rate for client to client internal coverage positions be expanded to include a broader population of long-short pairs
2. *Margin Loan Treatment:* Margin Loans be included in LCR inflows if the terms of the loan require posting of additional collateral or early payment of cash in response to changes in the client's market position. Additionally, Margin Loans funded with > 30 day liabilities be recognized as an inflow in the LCR on unwind of the transaction
3. *Linked Transaction:* Recognition of a 100% inflow in the event that a bank has borrowed a security in return for cash in order to facilitate a customer short position
4. *Lock-up and Client Money Protection (CMP):* Client assets protected by15c3-3 or Client Money Protection regulation be exempted from 75% inflow cap
5. *Expand Definition of Equities for Denominator*: Secured lending transactions collateralized by non-U.S. equity securities be reflected in denominator of calculation as HQLA

Prime Brokerage Financing Activities Overview

- PBs finance their business using a mix of internal and external funding. The PB business model has five critical funding concepts:
- Internal Coverage
  - Use of one client's long to "cover" another client's short
- External Coverage
  - Use of client short sale proceeds to collateralize stock borrow to cover short
- External Funding
  - "Rehypothecation" of client long positions to raise cash to fund margin loans
- Cross Funding
  - Use of one client's cash to fund another client's margin loan (negligible source of funding post 2008)
- Cash Segregation
  - "Lock up" in segregated account client cash not used to cross fund margin loans



Internal Coverage Treatment

- LCR Proposed Rules recognize a 50% outflow rate where customer short positions “are covered by other customers’ collateral” [§ 32(j)(1)(v)]
  - LCR imposes a 50% outflow, rather than a 100% outflow, based on an understanding that customers are incentivized to maintain a balanced portfolio and that the loss of customer short positions would be accompanied by a decrease in customer long positions
- Different outflow rates applied to long-short pairs in the LCR create an asymmetry in treatment that does not reflect the liquidity risk in the event the short position is unwound
- The amount of customer short positions covered by other customers’ collateral varies with the order of allocation that a banking organization chooses to apply during the internalization process, which may result in either inventory securities or customer securities being utilized to cover customers’ short positions
- Often Firm longs represent hedges to client swaps as well as the create to lend business whereby the bank will create the inventory for the sole purpose of covering the client’s short, once the position is closed out the bank will unwind the long as there is no longer a purpose to hold
- Same liquidity risk considerations apply whether the collateral coverage comes from other customers or Firm inventory
  - Collateral sourcing depends on bank’s collateral internalization process – bank will apply collateral based on operational and market efficiencies, but liquidity profile will be the same
- <u>Recommendation</u>: The LCR’s 50% outflow rate for client to client internal coverage positions be expanded to include a broader population of long-short pairs

C

Margin Loan Treatment: PB Term Margin Loan Description

- Generally when a bank provides a client with a loan collateralized by securities (i.e., a margin loan) it is repayable upon demand by the bank, unless the bank has agreed to term provisions under which certain aspects of the margin loan are fixed for a specified period time, subject to various conditions set forth in the loan agreement.
- Under such an agreement, a bank will typically agree to a specified notice period ("term") during which time the bank agrees not to recall the margin loan, change the margin methodology or, in many cases, change the interest rate spread charged on the margin loan. The bank's agreements are subject to various conditions set forth in the loan agreement, in particular the margin requirements on the client's portfolio with the bank change as the portfolio exceeds the agreed upon thresholds. In particular, such specific requirements may include, among other things, a certain ratio of longs to shorts, concentration limits and other portfolio limitations. **Thus, to the extent that the composition of the portfolio changes (for example, the portfolio becomes more long-biased than contemplated in the agreement), the bank may be able to call the loan in whole or in part prior to the expiration of the term.**

What a term margin loan is:

- Fixes the margin methodology and often the interest rate spread charged on the margin loan for a specified period of time, subject to contractual portfolio conditions (i.e., portfolio composition requirements)
- **Bank has a first priority security interest in the securities collateralizing the loan; bank can foreclosure upon the securities following a default by the client**
- **Loan is fully collateralized**
- **Securities are marked to market daily which can result in additional margin being required in normal course and under stress conditions**
- Margin requirements are asset based lending terms (amount bank will lend is directly related to the portfolio it holds with the bank, it is not based on a credit analysis of the client)
- **Margin requirement is dynamic and will change as the composition of the assets being lent against change, which often will result in a partial paydown of the margin loan and / or additional collateral to be posted to the bank**
  - From a practical perspective, this would require the client to post additional collateral to the bank, thereby increasing it's exposure to the bank, during the period of stress

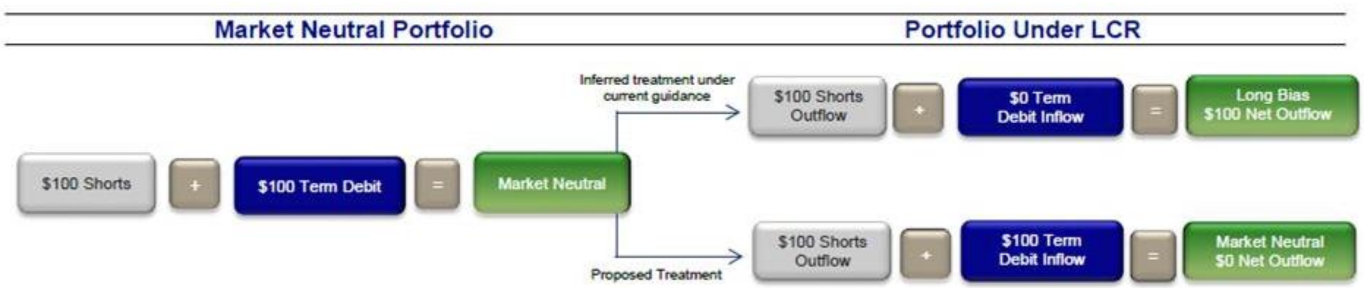
What a term margin loan is not:

- **Does not obligate the client to continue to borrow, they can repay the loan at any time**
- Does not require the bank to continue to lend to the client at the specified margin requirements (which drive the size of the margin loan) if the composition of the book changes
  - Directionality (amount of long vs. short)
  - Liquidity concentration
  - Sector concentration
  - Asset classes change

C

Margin Loan Treatment: Neutrality Clauses

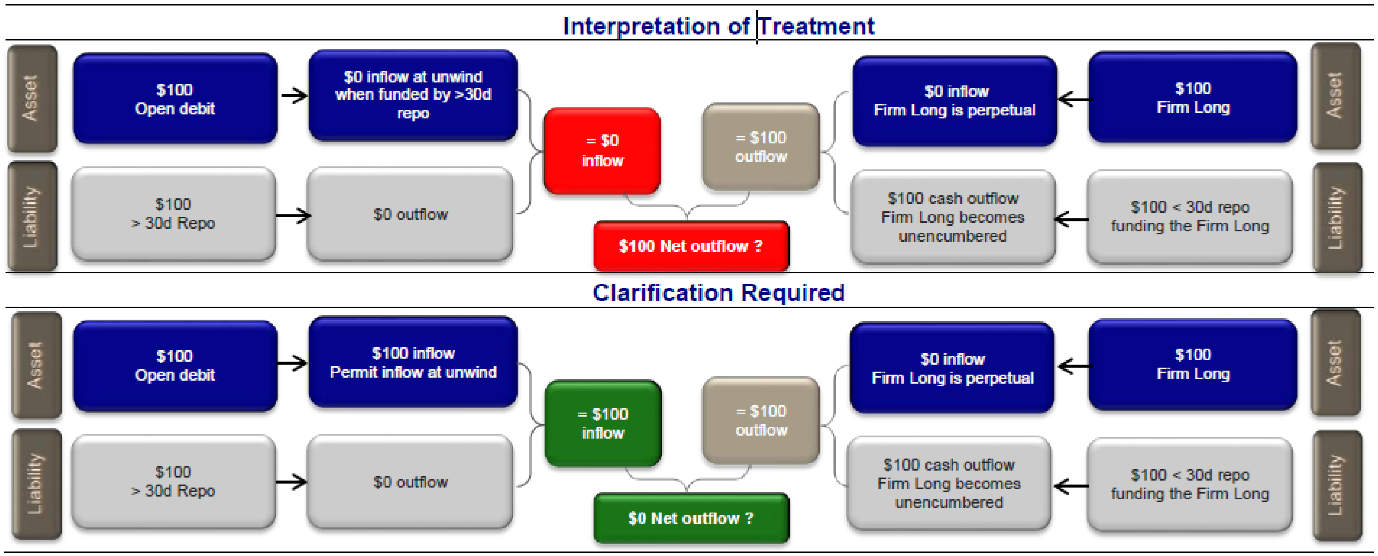
- LCR generally disqualifies recognition of inflows more than 30 days out
  - Specific attributes of margin loans merit LCR inflow recognition
- In 4Q2008, clients with term margin loans closed out their loans at the same rate as those with overnight margin loans as they reduced their market exposure
- Recommendation: Margin loans, irrespective of maturity date, may be included in LCR inflows, if the loans are subject to portfolio neutrality clauses or comparable arrangements that require posting of additional collateral, or early payment of cash, in response to changes in client's market position
  - Irrespective of maturity date, a client will be required to repay margin loans if there is a change in the market position of the client's portfolio
  - Excluding greater than 30 day margin loans from the LCR would result in unrealistic reflections of available liquidity resources



C

Margin Loan Treatment: Funding Sources

- On the issue of < 30 day margin loans funded with > 30 day liabilities, we have illustrated below how inflows would be generated in a stress environment
- The maturity of < 30 day repos within the LCR recognizes that the collateral securing < 30 day repos becomes unencumbered. (**liquidity drained**) That collateral is therefore available for pledging into > 30 day repo capacity that is freed up from margin loan unwinds (**liquidity recouped**). Accordingly, inflows from < 30 day margin loans funded by > 30 day liabilities should be recognized.
- Disallowing the inflow of < 30 day debits when funded with > 30 day repo incentivizes funding assets with short-dated liabilities. We do not believe this to be the Agencies' intended objective, given prudent asset and liability management ensures stability of financing in a stressed funding market. NSFR similarly incentivizes the funding of assets with term liabilities.
- **Recommendation**: Inflows from < 30 day margin loans funded by > 30 day liabilities should be recognized



D

Operationally Linked Transactions

- 75% Inflow cap imposed by the LCR: Based on market realities and observed liquidity management practices, we recommend specific exemptions to the 75% cap be considered
- Operationally, when a borrow is returned to a lender it is done via a DVP / RVP settlement such that the full amount of the collateral is returned to the bank at the same time the stock is returned to the lender
- Under Regulation T, broker-dealers are permitted to engage in securities borrowing transactions solely for a permitted purpose, such as to make delivery of a security. In the event that the client transaction is unwound, the bank no longer has a purpose for this position

- Recommendation: Recognize a 100% inflow where a bank has borrowed a security to facilitate a customer short position
- Symmetrical, offsetting transactions with credit, liquidity, market and operational risk safeguards
  - Both transaction legs are unwound simultaneously
  - Bank acts only as an intermediary; bank itself is market risk neutral
  - Imposing 75% inflow cap would impose unnecessary liquidity pricing drag

E

Lockup and Client Money Protection (CMP)

Customer lock up and CMP are subject to the LCR 75% inflow cap

Rationale: Applying a cap on inflows that a covered company is contractually entitled to receive within 30 days of the calculation date or where the inflow is directly correlated with an outflow creates an asymmetry

- Client assets deposited above certain limits and subject to customer protection create a flow of funds directly into segregated accounts ("lock up")
- Client assets are subject to a specific regulatory regime to ensure availability of funds
- Outflow of client balances would be funded by the cash held in the segregated accounts.
  - Applying a 75% cap on the inflow of funds implicitly assumes that 25% of the segregated funds are not available, which does not accurately reflect the true flow of funds
  - Broker-dealers may rely on these funds whenever debits exceed credits; no market risk or timing risk, as with other funding sources

- Recommendation: The LCR rules should distinguish between contractual and contingent inflows and only apply the 75% cap against the contingent inflows

Recommendation to specify a clear process for recognizing non-US equities as Level 2B

- US entities will often hold high-quality non-US equities to meet liquidity needs outside the United States
- US proposed rules refer to a process by which banks would demonstrate the reliability of non-US equities to the Agencies, but does not clarify how that process would work in practice
- We believe that non-US equities from major market indices and Exchange Traded Funds (U.S. and non-U.S.) that match these indices can be an important liquidity resource for US banks that have non-US liquidity needs and that the Agencies should permit the banks to demonstrate the reliability of entire non-US indices for this purpose
- Reliability determinations could be made based on market data and empirically back-tested

Secured lending transactions collateralized by non-U.S. equity securities

- The U.S. Proposed Rules limit Level 2B assets to equities included in the S&P 500 or other equities approved by the Agencies on a case-by-case basis
  - Stringent asset standards make sense for the LCR numerator, since these securities are a bank's liquidity pool
  - All non-U.S. equities would be subject to 100% outflow rates in the LCR denominator. Applying such stringent standards would likely result in odd outcomes in secured lending transactions

- <u>Recommendation</u>: For purposes of the secured lending transactions in the LCR denominator, a broader class of non-U.S. equity securities qualifies as Level 2B assets
  - Major international indices and Exchange Traded Funds that match these indices qualify as Level 2B assets for this purpose
  - This approach would ensure consistent practices across major equity markets, avoiding pricing impacts based on U.S. regulatory distinctions

Annex: Illustrative list of reliable equity indices in major jurisdictions

Country	Name of index
Australia	All Ordinaries, AS51
Austria	Austrian Traded Index
Belgium	BEL 20
Canada	S&P/TSX Composite Index
France	CAC 40, SBF 250
Germany	DAX, HDAX, CDAX
European	Dow Jones Stoxx 50 Index, FTSE Eurotop 300
Hong Kong	Hang Seng 33, HSCEI, HSCI
Italy	MIB 30
Japan	Nikkei 225
Korea	Kospi
Netherlands	AEX, AMX
Singapore	Straits Times Index
Spain	IBEX 35
Sweden	OMX
Switzerland	SMI, SPI
United Kingdom	FTSE 100, FTSE Mid 250, FTSE All Share
United States	S&P 500, Russell 1000, Russell 3000

Appendix 1: U.S. Market Volume Data

Equity Index Analysis

Index	Price Transparency	Market Size	Trading Volume	Price Volatility	
	Price Transparency	Average Daily Index Market Capitalization ($Tn)	Average Daily Volume ($bn)	Average Daily 2 Standard Deviation % Price Movement	Maximum 30-Day Price Decline
S&P 500	Yes	USD 10.97	USD 100.94	3.45%	30.87% (Oct10, 2008)
Russell 1000	Yes	USD 12.39	USD 115.43	3.47%	31.09% (Oct27, 2008)
Russell 3000	Yes	USD 13.58	USD 125.71	3.52%	31.54% (Oct10, 2008)

[1] Average of daily total index market capitalization from January 2008 to June 2012. Source: Bloomberg
[2] Average of aggregate daily index trading volume of underlying index components as of January 2014 over the period of January 2008 to June 2012. Source: Bloomberg
[3] Maximum total price decline over rolling 30 days from January 2008 to June 2012. Source: Bloomberg
[4] Index analysis includes financials and components of index will overlap

Equity Index Analysis

Volume/Shares outstanding

- **2008**

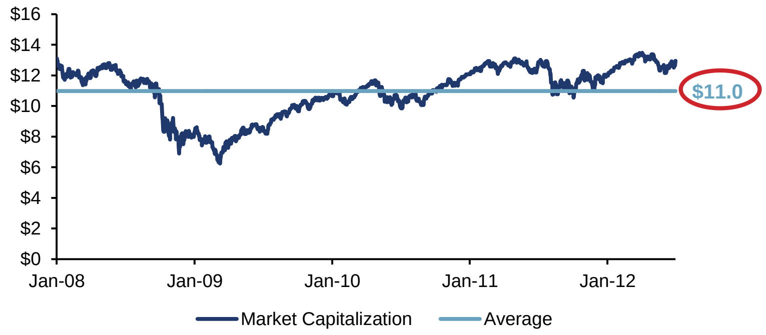
Index	Overall	Top 10%	Middle 80%	Bottom 10%	Bottom 5%	Bottom 3%
S&P500	1.60%	4.92%	1.32%	0.47%	0.40%	0.35%
Russell 1000	1.58%	4.99%	1.27%	0.34%	0.23%	0.17%
Russell 3000	1.30%	4.48%	0.99%	0.16%	0.10%	0.07%

- **2008 – 2014**

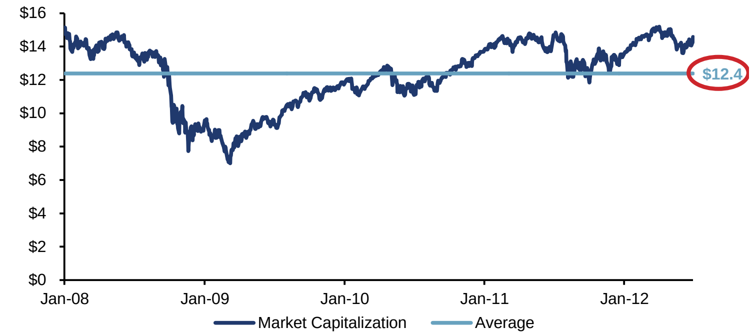
Index	Overall	Top 10%	Middle 80%	Bottom 10%	Bottom 5%	Bottom 3%
S&P500	1.29%	4.01%	1.05%	0.40%	0.34%	0.31%
Russell 1000	1.27%	4.13%	1.01%	0.28%	0.20%	0.15%
Russell 3000	1.03%	3.91%	0.76%	0.12%	0.08%	0.06%

Equity Index Analysis

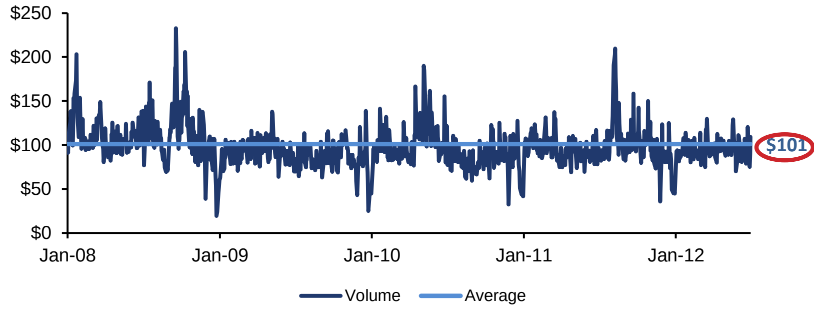
S&P 500 Stock Market Capitalization ($Tn)



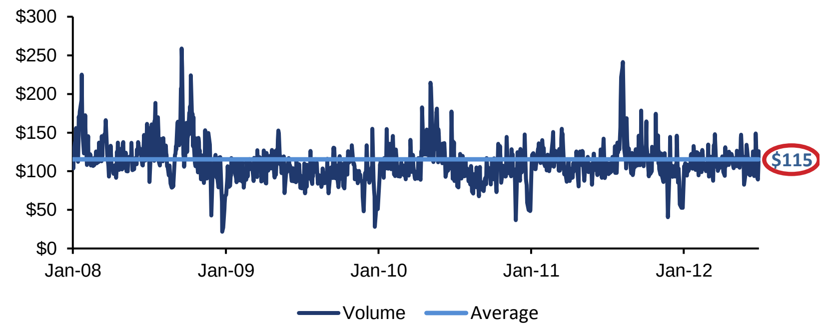
Russell 1000 Stock Market Capitalization ($Tn)[1]



S&P 500 Stock Trading Volumes ($bn)



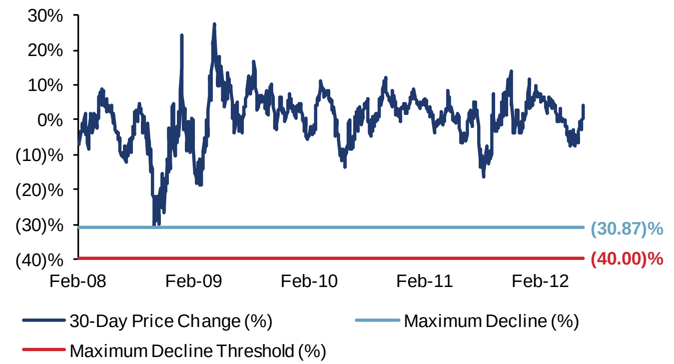
Russell 1000 Stock Trading Volumes ($bn)[2]



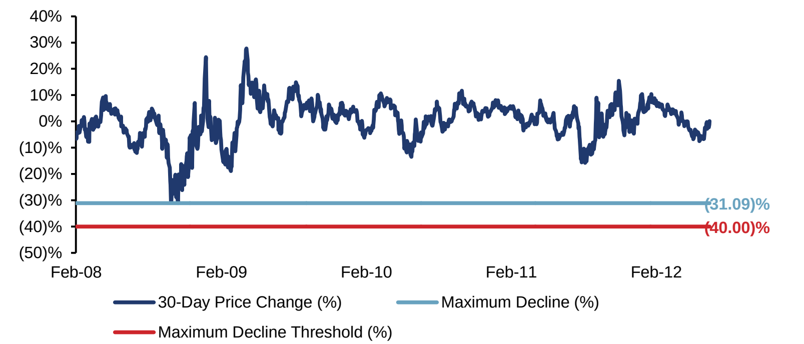
[1] *Daily index market capitalization and price of underlying index components over the period of January 2008 to June 2012. Source: Bloomberg*
[2] *Daily index trading volume of aggregate underlying index components as of January 2014 over the period of January 2008 to June 2012. Source: Bloomberg*

Equity Index Analysis

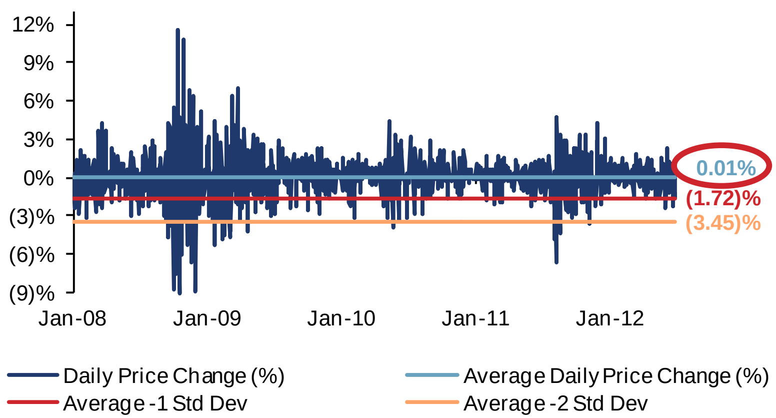
30-Day S&P 500 Price Change



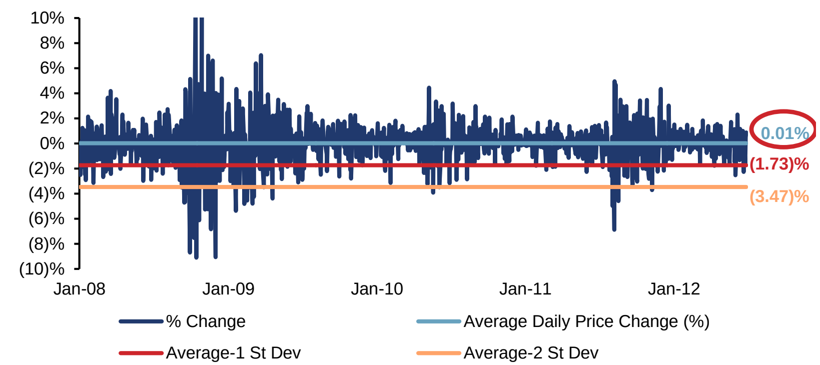
30-Day Russell 1000 Price Change[1]



Standard Deviation of Daily S&P 500 Price Change[1]



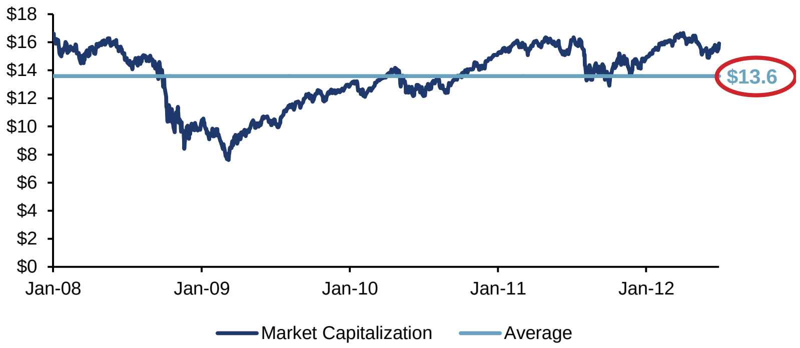
Standard Deviation of Daily Russell 1000 Price Change[1]



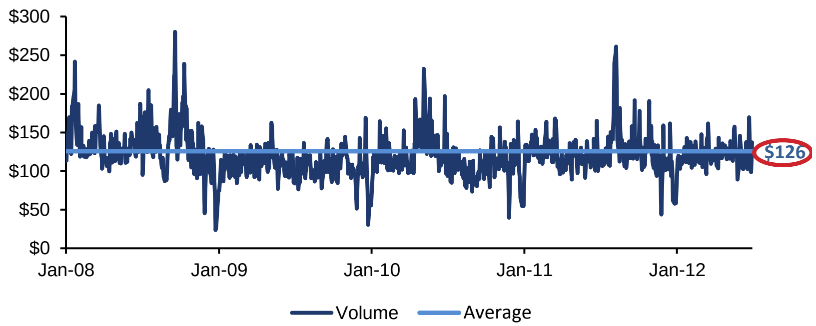
[1] *Daily index market capitalization and price of underlying index components over the period of January 2008 to June 2012. Source: Bloomberg*

Equity Index Analysis

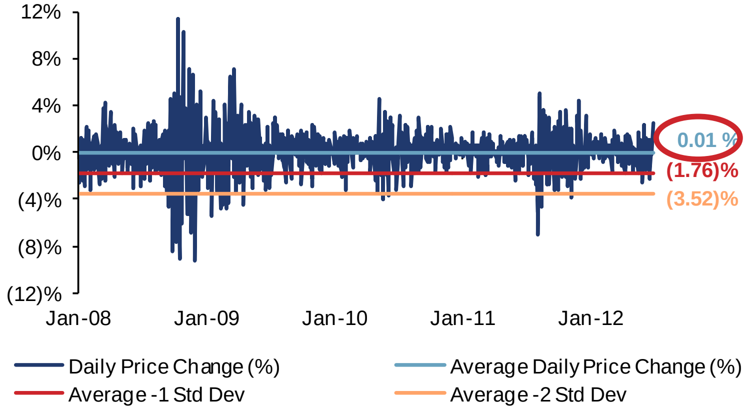
Russell 3000 Stock Market Capitalization ($Tn) [1]



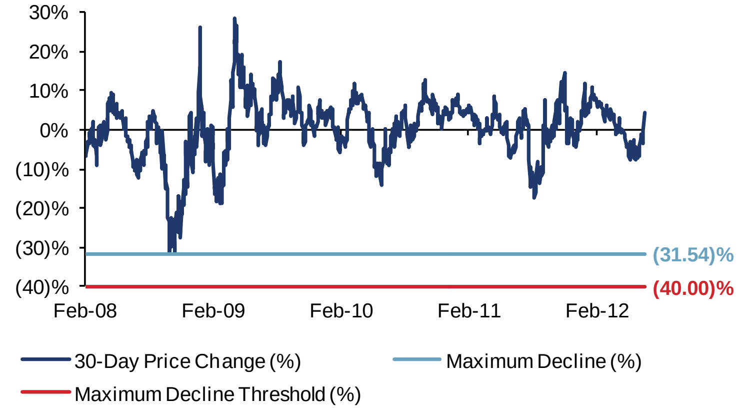
Russell 3000 Stock Trading Volumes ($bn) [2]



Standard Deviation of Daily Russell 3000 Price Change[1]



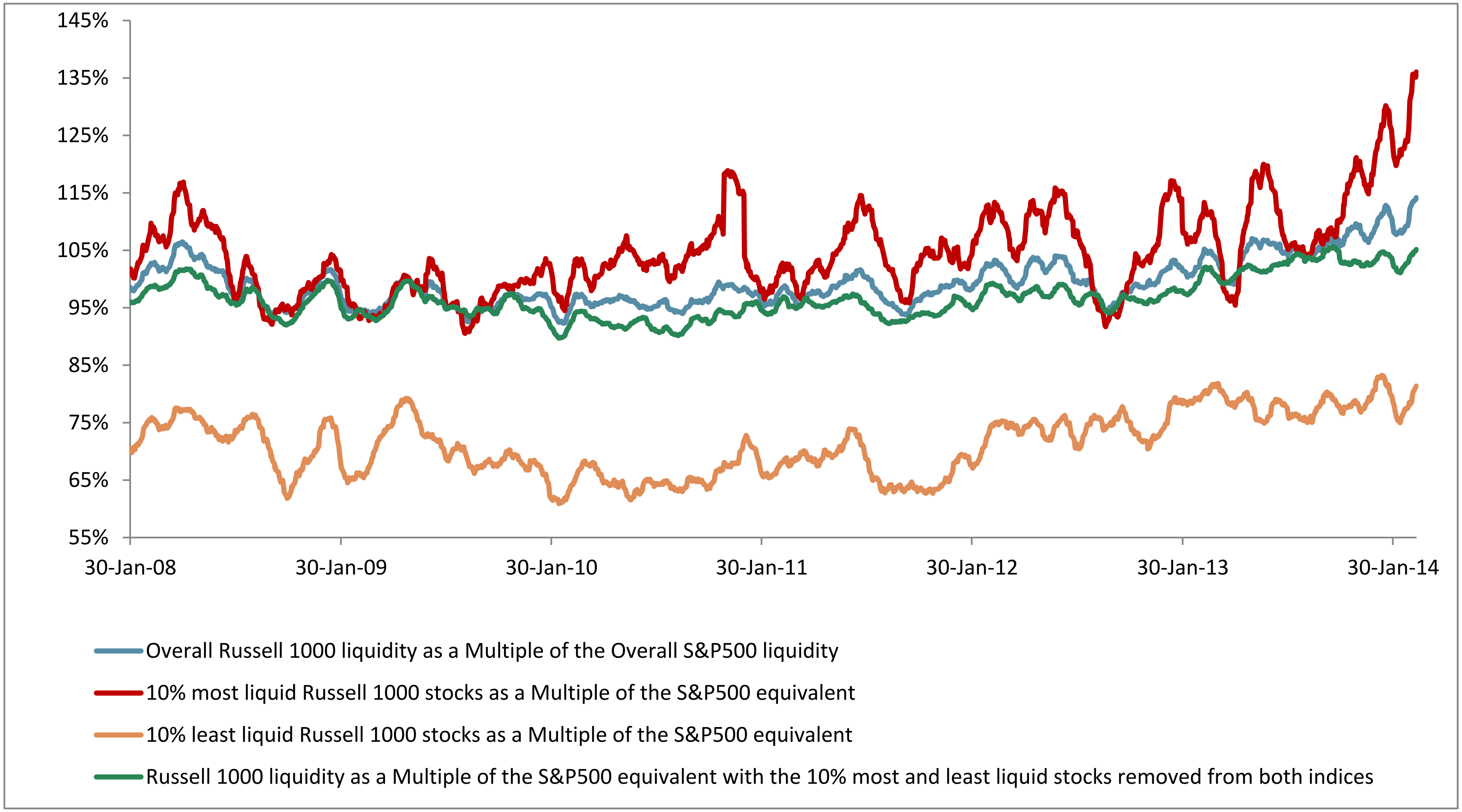
30-Day Russell 3000 Price Change[1]



[1] *Daily index market capitalization and price of underlying index components over the period of January 2008 to June 2012. Source: Bloomberg*
[2] *Daily index trading volume of aggregate underlying index components as of January 2014 over the period of January 2008 to June 2012. Source: Bloomberg*

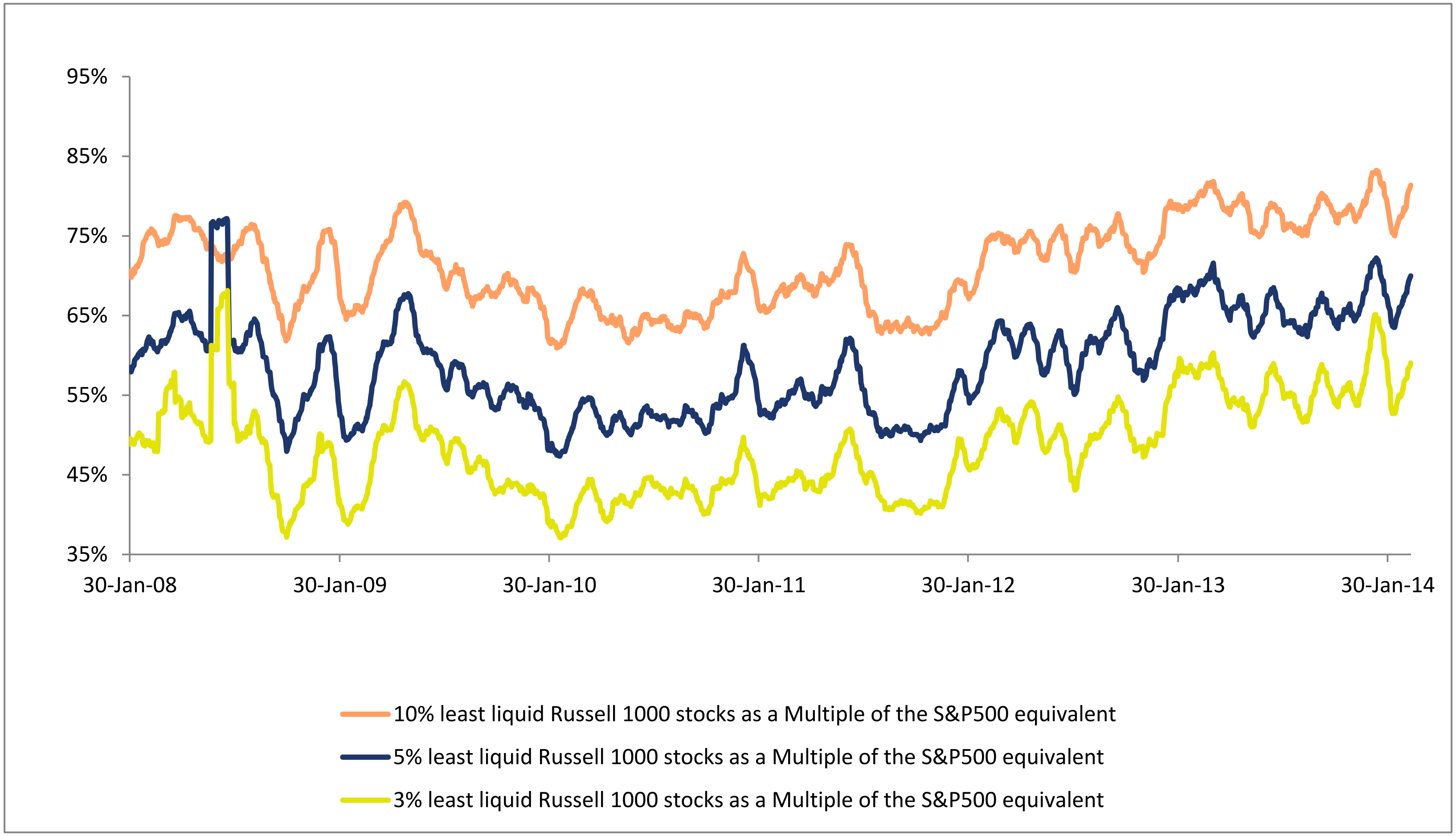
Equity Index Analysis

Russell 1000 Volume/Shares outstanding as a Multiple of S&P500 Volume/Shares outstanding (4-week average)



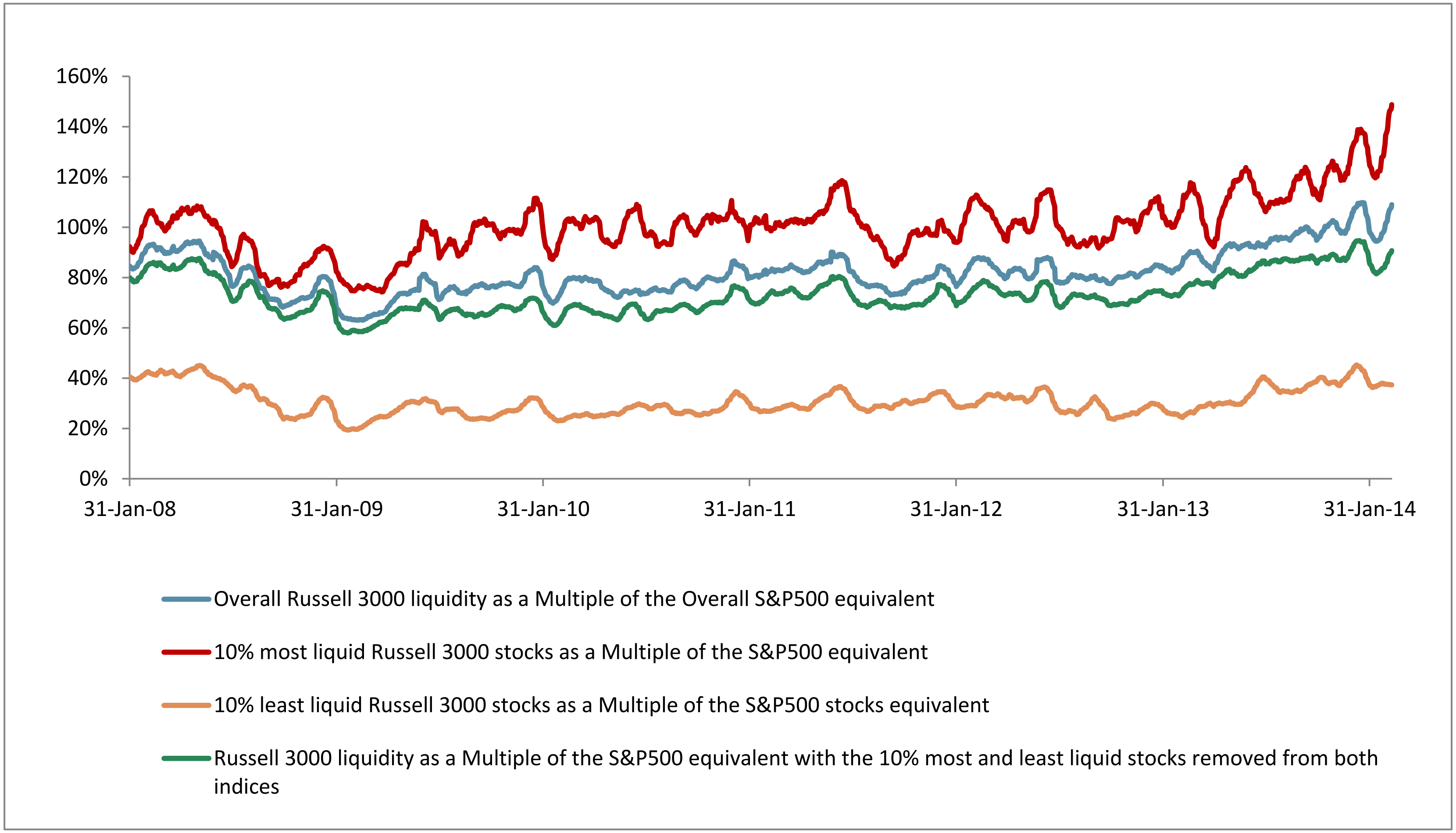
Equity Index Analysis

Russell 1000 Volume/Shares outstanding as a Multiple of S&P500 Volume/Shares outstanding (4-week average) - Tail



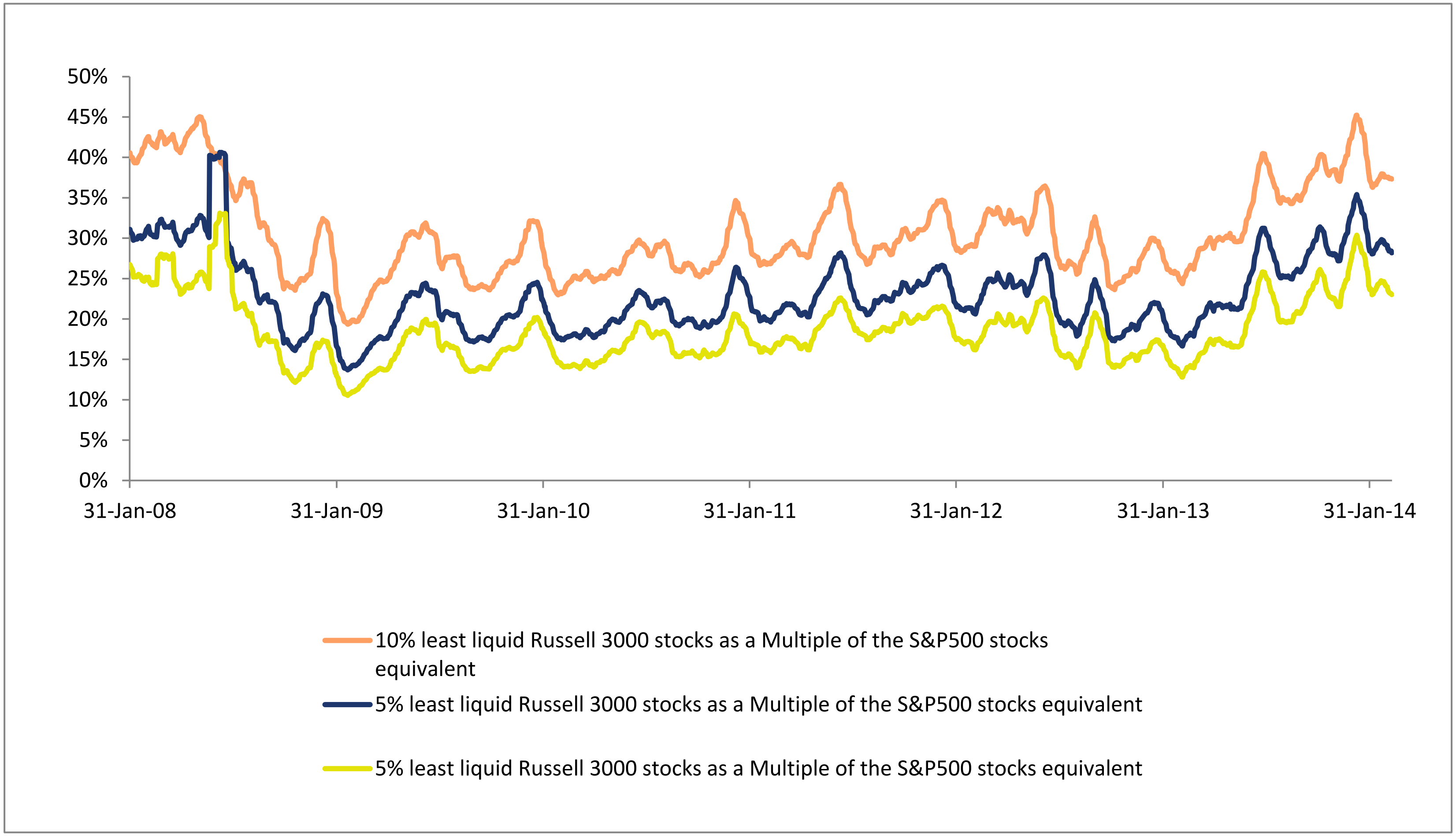
Equity Index Analysis

Russell 3000 Volume/Shares outstanding as a Multiple of S&P500 Volume/Shares outstanding (4-week average)



Equity Index Analysis

Russell 3000 Volume/Shares outstanding as a Multiple of S&P500 Volume/Shares outstanding (4-week average) - Tail



§ __.3 Definitions.

For the purposes of this part:

. . . .

Long-short pairs in the customer flow means instances where the [BANK] has sourced collateral internally or externally to cover customer short positions or secured loans.

Portfolio neutrality clause means a contractual term in a secured lending transaction agreement pursuant to which the margin requirement attributable to the portfolio increases in proportion to the lack of market neutrality in the customer's portfolio.

Secured funding transaction means any funding transaction that gives rise to a cash obligation of the [BANK] to a counterparty that is secured under applicable law by a lien on specifically designated assets owned by the [BANK] that gives the counterparty, as holder of the lien, priority over the assets in the case of bankruptcy, insolvency, liquidation, or resolution, including repurchase transactions, long-short pairs in the customer flow, and other secured loans.

Secured funding transactions also include borrowings from a Federal Reserve Bank.

Secured funding transaction that could extend beyond 30 days means instances where the [BANK] has either sold short a security or any secured funding transaction with a maturity date more than the 30 calendar days following the calculation date.

Secured lending transaction means any lending transaction that gives rise to a cash obligation of a counterparty to the [BANK] that is secured under applicable law by a lien on specifically designated assets owned by the counterparty and included in the [BANK]'s HQLA amount that gives the [BANK], as holder of the lien, priority over the assets in the case of bankruptcy, insolvency, liquidation, or resolution, including reverse repurchase transactions, margin lending transactions, and securities borrowing transactions. If the specifically designated assets are not included in the [BANK]'s HQLA amount but are still held by the [BANK], then the transaction is an unsecured wholesale funding transaction. See unsecured wholesale funding.

§ __.30 Total net cash outflow amount.

As of the calculation date, a [BANK]'s total net cash outflow amount equals the largest difference between cumulative inflows and cumulative outflows, as calculated for each of the next 30 calendar days after the calculation date as:

(a) The sum of the outflow amounts calculated under § __.32(a) through § __.32(g)(2); plus

(b) The sum of the outflow amounts calculated under § __.32(g)(3) through § __.32(l) for instruments or transactions that have no contractual maturity date; plus

(c) The sum of the outflow amounts for instruments or transactions identified in § __.32(g)(3) through § __.32(l) that have a contractual maturity date up to and including that calendar day; less

(d) The lesser of:

(1) The sum of the inflow amounts under § __.33(b) through § __.33(i), where the instrument or transaction has a contractual maturity date up to and including that calendar day and

(2) The sum of:

(i) 75 percent of the sum of paragraphs (a), (b), and (c) of this section as calculated for that calendar day, and

(ii) The sum of the inflow amounts calculated under § __.33(g) through § __.33(h).

§ __.32 Outflow amounts.

. . . .

(j) Secured funding and asset exchange outflow amount. (1) A [BANK]'s secured funding outflow amount as of the calculation date includes:

(i) 0 percent of all funds the [BANK] must pay pursuant to secured funding transactions, to the extent that the funds are secured by level 1 liquid assets;

(ii) 15 percent of all funds the [BANK] must pay pursuant to secured funding transactions, to the extent that the funds are secured by level 2A liquid assets;

(iii) 25 percent of all funds the [BANK] must pay pursuant to secured funding transactions with sovereign, multilateral development banks, or U.S. government-sponsored enterprises that are assigned a risk weight of 20 percent under subpart D of [AGENCY CAPITAL REGULATION], to the extent that the funds are not secured by level 1 or level 2A liquid assets;

(iv) 50 percent of all funds the [BANK] must pay pursuant to secured funding transactions, to the extent that the funds are secured by level 2B liquid assets;

(v) 50 percent of all funds received from long-short pairs in the customer flow that are covered by assets that are not HQLA; and

(vi) 100 percent of all other funds the [BANK] must pay pursuant to secured funding transactions, to the extent that the funds are secured by assets that are not HQLA.

§ __.33 Inflow amounts.

. . . .

(a) The inflows in paragraphs (b) through (i) of this section do not include:

. . . .

(6) Amounts payable to the [BANK] on any exposure that has no contractual maturity date or that matures after 30 calendar days of the calculation date, with the exception of amounts payable to the [BANK] on any exposure from a secured lending transaction governed by a portfolio neutrality clause; and

(7) Amounts due from secured lending transactions if the inflow received is required to re-collateralize secured funding transactions that could extend beyond 30 days.

. . . .

(f) Secured lending and asset exchange cash inflow amount. (1) A [BANK]'s secured lending cash inflow amount as of the calculation date includes:

. . . .

(v) 50 percent of all contractual payments due to the [BANK] pursuant to collateralized margin loans extended to customers, or other amounts due from secured lending transactions governed by a portfolio neutrality clause, provided that the loans are not secured by HQLA and the [BANK] is not using the collateral to cover any of its short positions.

(g) Customer asset protection regime inflow amounts. The customer asset protection regime inflow amount includes 100 percent of amounts deposited by the [BANK], or a consolidated subsidiary of the [BANK], in a segregated bank account at an unaffiliated insured depository institution pursuant to a customer asset protection regime, including Securities Exchange Act of 1934 Rule 15c3-3 and comparable customer asset protection regimes outside the United States.

(h) Secured lending transactions to facilitate customer transactions. The customer facilitation inflow amount includes 100 percent of all contractual payments due to the [BANK] pursuant to secured lending transactions where the [BANK] acquires a security to facilitate a customer transaction, including customer short positions, and the [BANK] has the legal right and ability to close-out the secured lending transaction simultaneously with the customer transaction.

(i) Other cash inflow amounts. A [BANK]'s inflow amount as of the calculation date includes 0 percent of other cash inflow amounts not included in paragraphs (b) through (h) of this section.

(j) Excluded amounts for intragroup transactions. The inflow amounts set forth in this section do not include amounts arising out of transactions between:

(1) The [BANK] and a consolidated subsidiary of the [BANK]; or

(2) A consolidated subsidiary of the [BANK] and another consolidated subsidiary of the [BANK].