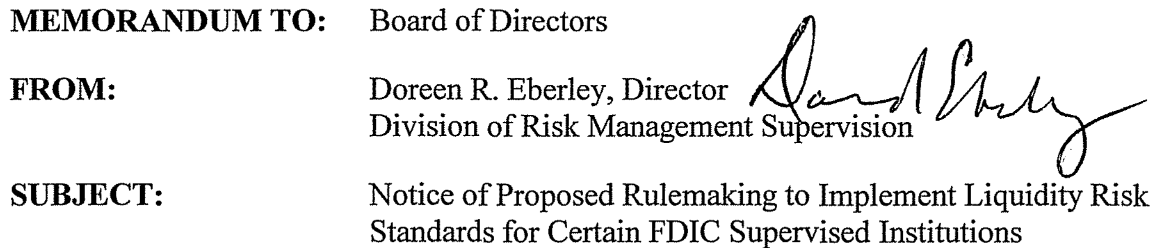
October 30, 2013

**MEMORANDUM TO:** Board of Directors



**FROM:** Doreen R. Eberley, Director
Division of Risk Management Supervision

**SUBJECT:** Notice of Proposed Rulemaking to Implement Liquidity Risk Standards for Certain FDIC Supervised Institutions

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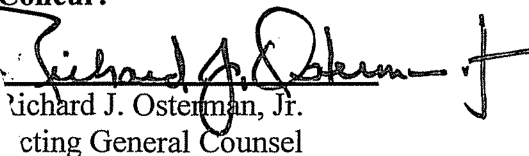
**Recommendation:** Staff recommends that the FDIC Board ("Board") approve publication in the *Federal Register* of the attached Notice of Proposed Rulemaking ("NPR" or "proposed rule") that would implement quantitative liquidity requirements, including a liquidity coverage ratio ("LCR"), consistent with liquidity standards adopted by the Basel Committee on Banking Supervision ("BCBS") in January 2013, for certain banking organizations with more than $250 billion in total assets or more than $10 billion in on-balance sheet foreign exposure; certain nonbank companies designated by the Financial Stability Oversight Council ("FSOC") for supervision by the Board of Governors of the Federal Reserve System ("FRB"); and their consolidated subsidiary depository institutions with $10 billion or more in total consolidated assets. The NPR also contains a separate proposal by the FRB to apply a modified version of the LCR to certain depository institution holding companies with assets greater than $50 billion. If approved, the NPR would be issued jointly by the FDIC, the FRB, and the Office of the Comptroller of the Currency ("OCC") (collectively, "the agencies") and would be published in the *Federal Register* with a comment period that would end on January 30, 2014.

**Concur:**



Richard J. Osterman, Jr.
Acting General Counsel

Staff has carefully considered the potential impact of this NPR, and has sought to minimize any implementation burden associated with the proposal to the extent possible.

## I. Background

The recent financial crisis demonstrated significant weaknesses in the liquidity positions of financial sector entities, many of which experienced difficulty meeting their obligations due to a breakdown of the short term funding markets. As a result, governments and central banks across the world provided unprecedented levels of liquidity support to financial sector entities in an effort to sustain the global financial system. In the United States, the FRB and the FDIC established various temporary liquidity facilities to provide sources of funding for a range of asset classes.

The rapid reversal in market conditions and the declining availability of liquidity during the financial crisis illustrated both the speed with which entity-specific and system-wide liquidity can evaporate and the potential for protracted illiquidity during and following these types of market events. In addition, the recent financial crisis highlighted the pervasive detrimental effect of a liquidity crisis on the banking sector, the financial system, and the economy as a whole.

Recognizing the need for banking organizations to improve their liquidity risk management and to control their liquidity risk exposures, the agencies worked with regulators from foreign jurisdictions to establish international liquidity standards. These standards include the principles based on supervisory expectations for liquidity risk management in the "*Principles for Sound Liquidity Management and Supervision*" ("Basel Liquidity Principles").[1] In addition to these principles, the BCBS established quantitative standards for liquidity in the "*Basel III:*

[1] Principles for Sound Liquidity Risk Management and Supervision (Sept. 2008), available at http://www.bis.org/publ/bcbs144.pdf (the "Basel Liquidity Principles").

*International framework for liquidity risk measurement, standards and monitoring*"[2] in December 2010, which introduced a liquidity coverage ratio ("2010 LCR") and a net stable funding ratio ("NSFR"), as well as a set of liquidity monitoring tools. Subsequently, in January 2013, the BCBS issued "*Basel III: The Liquidity Coverage Ratio and liquidity risk monitoring tools*" ("Basel III LCR"),[3] which updated key components of the 2010 LCR as part of the Basel III liquidity framework.[4]

The Basel III LCR establishes an international quantitative liquidity standard that is intended to promote the short-term resilience of the liquidity risk profile of international banking organizations. The Basel III LCR is also designed to improve the financial sector's ability to absorb, without reliance on government support, shocks arising from financial and economic stress, thus reducing the risk of spillover from the financial sector to the broader economy.

Beginning in January 2015, under the Basel III LCR, internationally active banking organizations would be required to hold sufficient high-quality liquid assets ("HQLA") to meet their obligations and other liquidity needs during a 30-day stress scenario. To meet the Basel III LCR standard, the HQLA must be unencumbered by liens and other restrictions on transferability so that they can be converted into cash easily and immediately in deep, active private markets.

Currently, U.S. banking organizations are not required to meet a quantitative liquidity standard. Rather, the agencies evaluate a banking organization's methods for measuring,

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

[3] Basel III: The Liquidity Coverage Ratio and liquidity risk monitoring tools (Jan. 2013), available at http://www.bis.org/publ/bcbs238.pdf (the "Basel III LCR").

[4] Key provisions of the 2010 LCR that were updated by the BCBS in 2013 include expanding the definition of high-quality liquid assets, technical changes to the calculation of various inflow and outflow run-off amounts, introducing a phase-in period for implementation, and a variety of rules text clarifications. *See* http://www.bis.org/press/p130106b.pdf for a complete list of revisions to the 2010 LCR.

monitoring, and managing liquidity risk on a case-by-case basis in conjunction with the supervisory process.[5] Since the financial crisis, the agencies have worked to establish a more rigorous supervisory and regulatory framework for U.S. banking organizations that would incorporate and build upon the BCBS liquidity standards. For example, the agencies, together with the National Credit Union Administration and the Conference of State Bank Supervisors, in March 2010 issued guidance titled the "*Interagency Policy Statement on Funding and Liquidity Risk Management*" ("Liquidity Risk Policy Statement"),[6] which incorporates elements of the Basel Liquidity Principles. The Liquidity Risk Policy Statement specifies supervisory expectations for fundamental liquidity risk management practices, including comprehensive processes for identifying, measuring, monitoring, and controlling liquidity risk. The Liquidity Risk Policy Statement also highlights corporate governance, cash-flow projections, stress testing, ample liquidity resources, and formal contingency funding plans as necessary tools for effectively measuring and managing liquidity risk.

The proposed rule would provide a minimum liquidity coverage ratio that focuses on short-term liquidity risks while improving the ability of financial sector entities to absorb potential market and liquidity shocks in a severe stress scenario over the short term. The proposed minimum liquidity coverage ratio is consistent with the Basel III LCR, with modifications (discussed below) that reflect the particular characteristics and risks of the U.S. financial markets and regulatory framework.

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[5] For instance, the Uniform Financial Rating System adopted by the Federal Financial Institutions Examination Council (FFIEC) requires examiners to assign a supervisory rating that corresponds to a banking organization's liquidity position.

[6] 75 FR 13656 (March 22, 2010).

## II. Overview of the Proposed Rule

A. *Scope*

The proposed rule would establish a minimum liquidity coverage ratio applicable to all (1) bank holding companies, savings and loan holding companies that do not have significant insurance operations, and depository institutions with $250 billion or more in total assets or $10 billion or more in on-balance sheet foreign exposure;[7] (2) nonbank companies designated by the FSOC for supervision by the FRB under section 113 of the Dodd-Frank Act that do not have significant insurance operations; and (3) depository institutions with $10 billion or more in total consolidated assets that are consolidated subsidiaries of one or more of the foregoing (collectively, "covered companies").

The agencies are reserving the authority to apply the proposed rule to an entity not in one of the categories described above if it is determined that the application of the proposed liquidity coverage ratio would be appropriate in light of its asset size, level of complexity, risk profile, scope of operations, or risk to the financial system. A covered company would remain subject to the proposed rule until its primary Federal supervisor determines in writing that application of the proposed rule to the company is not appropriate in light of these same factors.[8]

There are currently two FDIC-supervised institutions that would be subject to the requirements of the proposed rule.

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[7] Total consolidated assets for the purposes of the proposed rule would be as reported on a covered banking organization's most recent year-end Consolidated Reports of Condition and Income (call report) or Consolidated Financial Statements for Bank Holding Companies, Federal Reserve Form FR Y-9C (or, for SLHCs not required to report on the FR Y-9C, its estimated total consolidated assets as of the most recent year end, calculated in accordance with the instructions to the FR Y-9C). Foreign exposure data would be calculated in accordance with the Federal Financial Institution Examination Council 009 Country Exposure Report.

[8] The agencies also are reserving the authority to require a covered banking organization to hold an amount of HQLA greater than otherwise required under the proposed rule, or to take any other measure to improve the covered bank's liquidity risk profile, if liquidity requirements as calculated under proposed rule are not commensurate with liquidity risks.

The FRB also is proposing on its own to implement a modified version of the liquidity coverage ratio as an enhanced prudential standard for bank holding companies and savings and loan holding companies without significant insurance or commercial operations that, in each case, have $50 billion or more in total consolidated assets. The FRB's proposal is not part of the common text that the Board is being asked to approve as part of this case but is amendatory text that is part of the FRB's rulemaking. The FRB has provided detailed supplemental NPR preamble language to clarify that the modified approach is intended only for FRB-supervised holding companies with between $50 billion and $250 billion in total assets and is not part of, nor does it modify the LCR requirements that are the subject of this case presentation.

B. *Liquidity Coverage Ratio*

The NPR would require a covered company to maintain an amount of HQLA meeting the criteria set forth in the proposed rule (the numerator of the ratio) that is no less than 100 percent of its total net cash outflows over a 30-day period (the denominator of the ratio), as calculated in accordance with the proposed rule. The proposed rule requires a covered company to calculate its liquidity coverage ratio daily, as of a time certain selected by the covered company that cannot be changed without the written approval of its primary Federal supervisor.

C. *The Numerator: High Quality Liquid Assets*

HQLA makes up the numerator of the liquidity coverage ratio subject to criteria and limitations that are meant to ensure that a covered company's HQLA amount only includes assets with a high potential to generate liquidity through sale, repurchase agreement, or other monetization during a stress scenario. These assets possess the characteristics associated with the most liquid assets covered companies typically hold.

### *1. Liquidity Characteristics of HQLA*

In identifying the types of assets that would qualify as HQLA, staff considered the following categories of liquidity characteristics, which are generally consistent with those of the Basel III LCR: (a) risk profile; (b) market-based characteristics; and (c) central bank eligibility.

*Risk Profile*

Assets that are appropriate for consideration as HQLA tend to be lower risk in the areas of liquidity risk, market risk, credit risk, inflation risk, foreign exchange risk, and the risk of subordination in a bankruptcy or insolvency. Assets appropriate for consideration as HQLA are expected to remain liquid across various stress scenarios and should not suddenly lose their liquidity upon the occurrence of a certain type of risk and generally experience "flight to quality" during a crisis, wherein investors sell their other holdings to buy more of these assets in order to reduce risk of loss and increase the ability to monetize assets as necessary to meet their own obligations.

*Marketability*

Assets appropriate for consideration as HQLA also generally are liquid and readily marketable. These assets tend to have active outright sale or repurchase markets at all times with multiple market makers, significant diversity in market participants on both buy and sell sides, timely and observable prices, and high trading volume. This market-based liquidity characteristic may be demonstrated by historical evidence, including bid-ask spreads, high trading volumes, a large and diverse number of market participants, and the presence of multiple committed market makers. Further, these assets generally tend to have prices that do not incur sharp price declines, even during times of stress. To the extent that an asset exhibits price or volume fluctuation during times of stress, assets appropriate for consideration as HQLA tend to

increase in value and experience a flight to quality during such times, as, historically, the market moves into more liquid assets in times of systemic crisis.

*Central Bank Eligibility*

Assets that a covered company can pledge at a central bank as collateral for intraday liquidity needs and overnight liquidity facilities in a jurisdiction and in a currency where the bank has access to the central bank generally tend to be liquid and, as such, are appropriate for consideration as HQLA. Central banks provide a backstop to the supply of banking system liquidity under conditions of severe stress and therefore central bank eligibility should provide additional assurance that assets could be used in acute liquidity stress events. Note that merely being central bank eligible is not enough for assets to qualify as HQLA; the other criteria of the proposed rule must be satisfied as well. Moreover, some assets which are not central bank eligible, such as certain publicly traded shares of common stock are not precluded from being eligible for HQLA.

*2. HQLA Categories*

*Level 1 HQLA*

Level 1 HQLA are the most liquid and high-quality of the assets, and a covered company may hold level 1 HQLA without limit and without haircuts. Level 1 HQLA include Reserve Bank excess balances, foreign withdrawable reserves, securities issued by or guaranteed by the U.S. government, certain issuances of international organizations assigned a 0 percent risk weight under the FDIC's capital rules, and certain debt of a foreign sovereign entity[9].

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[9] Covered companies would be able to count debt securities issued by foreign sovereigns and international organizations if they are assigned a 0 percent risk weight, are liquid and readily marketable, and have a proven record as a reliable source of liquidity in repurchase or sales markets during stressed market conditions. Covered companies would be able to count debt securities issued by foreign sovereigns assigned a risk weight greater than 0 percent only if the debt security is issued in the currency of the sovereign entity, and held to cover cash outflows in that jurisdiction. Moreover, all HQLA must meet the operational requirements set forth in the proposed rule.

*Level 2A HQLA*

Level 2A HQLA are slightly less liquid assets that include certain claims on, or claims guaranteed by a U.S. government sponsored enterprise (GSE)[10] and certain claims on, or claims guaranteed by, a sovereign entity or a multilateral development bank. All such assets would be required to be liquid and readily marketable, as described above, to be considered level 2A liquid assets. Level 2A liquid assets also would include claims on, or claims guaranteed by a sovereign entity or a multilateral development bank that: (1) is not included in level 1 liquid assets, (2) is assigned no higher than a 20 percent risk weight under the standardized approach for risk-weighted assets of the agencies' regulatory capital rules,[11] and (3) is issued by an entity whose obligations have a proven record as a reliable source of liquidity in repurchase or sales markets during stressed market conditions

Assets in this category are subject to a 15 percent haircut and, when combined with level 2B HQLA, can comprise no more than 40 percent of total HQLA.

*Level 2B HQLA*

Level 2B HQLA are the least liquid assets that qualify as HQLA. Level 2B liquid assets include certain publicly traded corporate debt securities and certain publicly traded shares of common stock that are liquid and readily marketable. Under the proposed rule, the definition of "publicly traded" would be consistent with the definition used in the agencies' regulatory capital rules and would identify securities traded on registered exchanges with liquid two-way markets where there are independent bona fide offers to buy and sell, so that a price reasonably related to

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[10] GSEs include the Federal Home Loan Mortgage Corporation (FHLMC), the Federal National Mortgage Association (FNMA), the Farm Credit System, and the Federal Home Loan Bank System.

[11] *See* 12 CFR 324.

the last sales price or current bona fide competitive bid and offer quotations can be determined and settled at that price within a short time frame. Because regulatory requirements obligate depository institutions to promptly divest equities acquired through debts previously contracted (DPC), depository institutions would be prohibited from including publicly traded common stock acquired DPC in their HQLA (however, the Federal Reserve rule will allow equities acquired DPC held at the holding company to be included in the consolidated requirement) and could include in their consolidated HQLA no more than would be permissible to cover the net cash outflows of a consolidated subsidiary.

Level 2B liquid assets are subject to a 50 percent haircut and may comprise no more than 15 percent of the total HQLA amount.

### 3. *Operational Requirements and Generally Applicable Criteria for HQLA*

Under the proposed rule, for HQLA to be included in the LCR, it must be unencumbered and available to be monetized in a liquidity stress scenario. Accordingly, the NPR proposes the following operational requirements:

- The covered company must have the operational capability to sell or transfer the HQLA;
- The covered company must implement policies that require all HQLA to be under the management function of the organization responsible for managing liquidity risk;
- The covered company must include in its total net cash outflow amount the amount of cash outflows that would result from the termination of any specific transaction hedging HQLA;
- The covered company must maintain policies and procedures that determine the composition of HQLA by legal entity, geographical location, currency, custodial or bank account, that monitor that the assets continue to qualify as HQLA, that ensure that assets are appropriately diversified by factors associated with the liquidity risk of the assets, and that the amount of HQLA held outside of the U.S. is appropriate in relation to the net cash outflows attributable to non-U.S. branches.

The following general criteria also apply to all HQLA:

- The assets must be free of restraint on transfer or sale and may not be pledged to secure credit that has been extended;
- The assets must not be segregated client pool securities or cash received from a transaction involving such securities;
- The assets may not be included if the covered company holds them pursuant to a rehypothecation right that would enable the beneficial owner to withdraw the assets; and
- Assets held in a consolidated subsidiary of a covered company may be included in the covered company's consolidated LCR in amount equal to the net cash outflows of the consolidated subsidiary plus any amount that may be transferred in accordance with statutory, regulatory, contractual, or supervisory restrictions.

The proposed rule also provides that a covered company is generally expected to maintain in the United States an amount and type of HQLA that is sufficient to meet its total net cash outflow amount in the United States. The agencies have asked questions in the preamble accompanying the proposed rule in an effort to determine the best way to provide for the free movement of liquidity to satisfy a covered company's needs in all of the jurisdictions in which it operates while minimizing the risk that HQLA may be trapped in one jurisdiction and therefore unable to meet a covered company's needs in another jurisdiction.

*4. Calculation of HQLA amount*

The NPR provides a formula for calculating a banking organization's HQLA that gives effect to the haircuts and caps imposed on level 2A and level 2B liquid assets, and also takes into account any repurchase-style transactions by calculating the amount of HQLA on both an unadjusted and adjusted (unwound) basis. Because the haircuts and caps would be applied both before and after unwinding those transactions, unwinding such repurchase-style transactions prevents a banking organization from having only level 2B HQLA but entering into a securities

borrowing or reverse repurchase arrangement that allows it to obtain level 1 and level 2A HQLA in exchange for level 2B, thereby misrepresenting the amount and type of HQLA it holds.

### D. *The Denominator: Net Cash Outflows*

Net cash outflows make up the denominator of the liquidity coverage ratio. The proposed rule assigns run-off and draw down rates to various sources of on- and off-balance sheet funding, based on the historical behavior and characteristics of those funding sources during periods of liquidity stress. These outflow rates would be multiplied by the outstanding balances of each category of funding to arrive at the applicable outflow amount, and then summed to determine the total cash outflow amount.

The total cash outflow amount generally may be offset by cash inflows, which are calculated by multiplying the outstanding balances of various types of contractual receivables by the inflow rates reflecting the staff's projections of counterparties' payments to the bank during the 30-day stress period. However, total expected cash inflows cannot under any circumstances exceed 75 percent of total expected cash outflows. This limitation is designed to account for the possibility that a portion of expected cash inflows may become unavailable in a short-term stressed environment, and, at a minimum, staff believes that at least one-quarter of the total expected cash outflow amount should be covered by HQLA.

#### *1. Classification of Maturities*

The proposed rule would require a covered company to calculate its net cash outflows over a 30-day stress period, so it is important to be able to determine what instruments will mature and what transactions will occur in that timeframe. Generally, a covered company must identify the maturity date that is the most conservative for the covered company. In the case of outflows, the proposed rule would require the covered company to treat the outflow as occurring

on the earliest possible day that it can occur. Thus, for example, the proposed rule would require the covered company not to give effect to any contractually required notice period, and to assume that a counterparty will exercise an acceleration clause if one exists.

Similarly, the proposed rule would require that inflows be recognized at the latest possible date. Thus, for example, if a borrower has an option that would extend the maturity of the loan, the proposed rule would require the covered company to assume that the borrower will exercise the option to extend the maturity to the latest possible date.

Certain outflows and inflows do not have a maturity date. Under the proposed rule, following the rule of conservatism, outflows without a maturity would be treated on occurring the first day after a calculation date while inflows without a maturity would be treated as occurring outside the 30-day period.

*2. Calculation of net cash outflows*

The Basel III LCR would require a covered company to calculate net cash outflows by adding all of the outflow amounts for the 30 days after a calculation date, adding all of the inflow amounts for the 30 days after a calculation date, and then offsetting total cash outflows against total cash inflows to arrive at net cash outflows. This approach, however, does not take into account the fact that outflows may occur earlier in the 30-day period than inflows, resulting in an incomplete picture of the covered company's cash flows and liquidity needs.

To address this issue, the proposed rule would require a covered company to calculate its total net cash outflow amount for each of the 30 calendar days following the calculation date, treating nonmaturity items as occurring on the first day after the calculation date and items with maturities or a contractual transaction date would be treated as occurring on that date. The net cash outflow amount to be used in the denominator of the LCR is the peak cumulative net cash

outflow amount, which is the single day during the 30-day with the highest cumulative net cash outflows. Under the proposed rule, the covered company would be required to hold, at a minimum, sufficient HQLA to cover this peak outflow, thereby ensuring that on any given day during that period that the covered company would hold HQLA in amount meeting or exceeding that day's net cash outflows. By requiring the recognition of the highest net cumulative cash outflow day of a particular 30-day stress period, the staff believes that the LCR would better capture a banking organization's liquidity risk and help foster more sound liquidity management.

E. *Liquidity coverage ratio shortfall*

The proposed rule would require a banking organization to report immediately to the appropriate Federal banking agency when its LCR falls below the minimum required level. Consistent with the Basel III LCR, staff recognizes that a covered company may need to use its HQLA during a period of liquidity stress that exceeds normal business fluctuations. To the extent that use of HQLA may cause a covered company's LCR to fall below the minimum requirement, staff is of the view that supervisory actions should not discourage or deter a covered company from using its HQLA.

If a covered company's LCR is below the minimum requirement for three consecutive days, or if the covered company's primary Federal supervisor determines that the covered company is otherwise materially noncompliant with the requirements of the proposed rule, the proposed rule would require the covered company to provide to the appropriate Federal banking agency a plan for achieving compliance with the minimum liquidity requirement and all other requirements of the proposed rule. The plan would be required to include, as applicable: (1) an assessment of the covered company's liquidity position; (2) the measures the covered company has taken and will take to achieve full compliance with the proposed rule, including (A) a plan

for adjusting the banking organization's risk profile, risk management, and funding sources in order to achieve full compliance with this part and (B) a plan for remediating any operational or management issues that contributed to noncompliance with the proposed rule; (3) an estimated timeframe for achieving full compliance with the proposed rule; and (4) a commitment to report to the appropriate Federal banking agency no less than weekly on progress to achieve compliance in accordance with the plan until full compliance with the proposed rule is achieved.

In addition, the proposed rule would make clear that each agency may, at its discretion, take additional supervisory action to address noncompliance with the established minimum liquidity coverage ratio.

F. *Transitions and timing*

Staff is proposing to implement a transition period for the proposed rule's liquidity coverage ratio that is more accelerated than the transition provided in the Basel III LCR. The proposed rule would require covered companies to comply with the minimum liquidity coverage ratio as follows: 80 percent on January 1, 2015; 90 percent on January 1, 2016; and 100 percent on January 1, 2017, and thereafter. The proposed transition period accounts for the potential implications of the proposed rule on financial markets, credit extension, and economic growth and seeks to balance these concerns with the NPR's important role in promoting a more robust and resilient financial sector. In staff's view, the information gathered from a subset of the covered companies to which the proposed rule would apply indicates that most covered companies would not require the longer transition times of the Basel III LCR.

G. *Reporting*

Staff anticipates implementing reporting and public disclosure requirements in a separate NPR. In the meantime, banking organizations will be responsible for calculating the LCR daily,

maintaining policies and procedures for the implementation of the LCR, and providing information to the appropriate Federal banking agency as requested.

## III. Conclusion

Staff recommends that the Board approve for publication in the *Federal Register* the attached NPR, which would establish a quantitative liquidity coverage ratio requirement for covered FDIC-supervised institutions. In addition to ensuring covered bank's liquidity in times of financial market distress, the uniform LCR requirement will provide the FDIC with current and forward-looking information to assist in assessments of a covered company's HQLA balanced against a reasonable assessment of net outflows, help to better identify potential downside risks and the potential impact of adverse outcomes on the liquidity of covered companies, and to assist in ensuring the financial stability not just of covered FDIC-supervised banks, but also covered companies. In this way, staff believes the LCR will be an important tool for the FDIC in its roles as primary Federal supervisor of FDIC-supervised institutions, as insurer of deposits, and as orderly liquidator of complex financial institutions.

**Contacts**

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