The Basel Liquidity NPR in a Nutshell*

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Last month, the Federal Reserve Board issued a notice of proposed rule-making that would establish minimum liquidity requirements for large banking organizations, internationally active banking organizations, and financial companies that have been designated as systemically significant by the Financial Stability Oversight Board. Both the OCC and the FDIC have issued similar proposed rules for banking institutions within their supervisory authority. This paper will provide a summary of the proposal "in a nutshell."

<u>Coverage</u>

The new liquidity requirements will apply, with certain narrow exceptions,[1] to the following:

- All banking organizations with $250 billion or more in consolidated assets, and their depository institution subsidiaries holding $10 billion or more in consolidated assets.
- All banking organizations that have $10 billion or more in foreign on-balance sheet exposures and their depository institution subsidiaries with at least $10 billion in assets.
- Non-banking financial organizations that have been designated as systemically significant by the Financial Stability Oversight Board (SIFIs), unless they are primarily engaged in insurance underwriting activities.

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[1]For example, exceptions from coverage are created for depository institution holding companies and SIFIs that are engaged primarily in insurance underwriting, and for grandfathered savings and loan holding companies that are primarily engaged in non-financial activities.

- A modified version of the liquidity rule will apply to depository institution holding companies that have between $50 billion and $250 billion in consolidated assets, and which do not have $10 billion or more in foreign on-balance sheet exposures.

The LCR Standard

The basic mandate in the NPR is to meet a "Liquidity Coverage Ratio" (LCR). The LCR requires a covered organization to maintain sufficient amounts of high quality liquid assets (HQLA) to withstand a 30 day run on the institution during periods of severe economic stress. To test the sufficiency of the liquidity reserve, the LCR specifies a "stress test" with stipulated deposit outflows and other liquidity demands.

A covered organization must monitor its liquidity levels daily. The covered entity must notify the appropriate regulator on any day that the minimum LCR level is breached. The company must submit a remedial plan if the LCR is not met for three consecutive days.[2] The pool of HQLA either must be segregated from other assets held by the covered company or the institution must demonstrate that it could monetize the assets and use the proceeds for liquidity management without conflicting with any other business risk or management plan.

High Quality Liquid Assets

Qualified liquidity assets must be easily and immediately converted into cash with little loss of value. The asset must be unencumbered and free of any impediment that would prevent the covered institution from converting the asset to cash, and cannot be used as a hedge against another position. An asset that is pledged, explicitly or *implicitly* , to provide credit enhancement to any position cannot be used. Further, assets that are obligations of financial companies (including depository institutions, depository institution holding companies, investment companies, hedge funds, private equity funds, commodity pool operators, investment advisors, SIFIs and subsidiaries thereof) may not be considered HQLA, even if all of the other standards are met.

[2] However, under the NPR, covered organizations are assumed to liquidate the pool of qualifying liquid assets to meet demands during periods of stress, and will not be in violation of the standard by so doing.

High quality liquid assets are divided into three classes or levels. Level 1 assets can be used to meet the liquidity test without limit. Level 2A assets can be counted for liquidity purposes, but are subject to a 15 percent haircut. Level 2B assets are subject to a 50 percent haircut. In addition, the aggregate amount of Level 2A and 2B assets cannot count towards more than 40 percent of the total required stock of high quality liquid assets, and Level 2B assets cannot count towards more than 15 percent of the total required amount.

Level 1 assets are essentially limited to:[3]

- Cash;
- Reserves held by a Federal Reserve Bank that can be drawn down;
- Reserves held by a foreign central bank that are not subject to restrictions;
- A security issued or unconditionally guaranteed by the Treasury;
- A security issued or unconditionally guaranteed by a U.S. government agency, if the obligation is *explicitly* guaranteed by the full faith and credit of the U.S.;
- Liquid and readily marketable securities issued or unconditionally guaranteed by a sovereign entity, the Bank for International Settlements, the IMF, the European Central Bank and European Community, or a multinational development bank, provided the security has a 0 risk weight, the issuer's obligations have a proven track record as a reliable source of liquidity during stressed conditions; and
- Securities issued by, or unconditionally guaranteed by, a sovereign entity that is not subject to a 0 risk weight, if the security is issued in the sovereign's currency, the security is liquid and readily marketable, and the covered institution is holding the security in order to meet its net cash outflows to that country.

Level 2A assets are:

[3] Other level 1 assets relate to government and central bank debt securities that match the currency of the liquidity risk.

- Marketable and liquid securities that are senior to preferred stock securities issued by a GSE; and
- Marketable and liquid securities issued by a sovereign entity or multilateral development bank that is assigned a 20 percent risk weight, and that have a proven track record as a reliable source of liquidity during stressed market conditions.

Level 2B assets are:

- Liquid and readily marketable and publicly traded corporate debt securities that are determined to be investment grade and are issued by an entity that has a proven track record as a reliable source of liquidity during stressed market conditions; and
- Publicly traded corporate equity securities included in the S&P 500 Index or similar index that indicates the securities are liquid and readily marketable. The issuing company must have a proven track record as a reliable source of liquidity during stressed market conditions.

Covered Bonds

The NPR states that the proposed rule "likely would not permit covered bonds ... to qualify as HQLA at this time." The NPR reasoned that covered bonds are not " liquid and readily-marketable in U.S. markets and thus do not exhibit the liquidity characteristics necessary to be included in HQLA under this proposed rule." The NPR also explained that "covered bonds, in particular, exhibit significant risks regarding interconnectedness and wrong-way risk among companies in the financial sector...."

Municipal Bonds

The NPR states that the proposed rule likely would not permit securities issued by public sector entities, such as a state, local authority, or other government subdivision below the level of a sovereign (including U.S. states and municipalities), to qualify as HQLA at this time.

Private Label Residential Mortgage Backed Securities

The NPR does not include residential mortgage-backed securities as HQLA.

Net Cash Outflows

Net cash outflows is the total amount of predicted cash outflows less the total amount of predicted cash inflows during the stress period. The NPR specifies parameters to be used in determining the net cash outflow. For example, the proposed rule states that the outflow calculation should assume that 3 percent of insured deposits will run off, and 10 percent of other retail deposits will leave the institution.

Under the proposal, all types of secured funding, including Federal Home Loan Bank advances, are subject to assumed outflow rates based on the quality of the assets securing the loan. If the funding is secured by Level 1 assets, the assumption is that there will be no outflow. The outflow rate is assumed to be 15 percent to the extent the collateral is a Level 2A asset. And the outflow rate is set at 25 percent to the extent the collateral is a Level 2B asset and the counterparty is a GSE, such as a Federal Home Loan Bank, or a sovereign. If the counterparty is not a GSE or sovereign, the outflow rate is increased to 50 percent.

Depository Institution Holding Companies with $50 Billion in Assets

As mentioned, the NPR has a modified LCR for depository institution holding companies with $50 billion or more in assets but less than $250 billion.[4] The modified standard would apply a 21 day stress test rather than the 30 day stress test applicable to larger institutions.

Phase-In of Effective Date

The NPR provides for a phase-in of the liquidity requirement beginning on January 1, 2015. For that calendar year, a covered company must hold 80 percent of the required amount of High Quality Liquid Assets. For calendar year 2016, the amount is 90 percent. Beginning on January 1, 2017, the covered company must fully comply.

This is a faster phase-in than what was agreed to internationally last January. According to the international agreement, the phase-in starts on January 1, 2015, with compliance set at 60 percent, and the amount is increased 10 percent each year until full compliance is reached by January 1, 2019. The original international agreement called for full implementation

[4] And which do not have $10 billion or more in on-balance sheet foreign exposures.

of the LCR as of January 1, 2015. The new agreement provides for a phase-in of the LCR. Under the new agreement, banking organizations must have 60 percent of the required amount of liquidity reserve as of January 1, 2015. In each of the following four years, the required percent of liquidity reserve increases by 10 percent so that by January 1, 2019, banking institutions must hold 100 percent of the required liquidity.

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