January 15, 2013

Basel III Liquidity Framework

Basel Committee Publishes Changes to the Liquidity Coverage Ratio

BACKGROUND AND SUMMARY

On January 7, 2013, the Basel Committee on Banking Supervision (the "*Basel Committee*") published the full text (the "*revised LCR standard*")[1] of the revised Basel III Liquidity Coverage Ratio (the "*LCR*"), incorporating amendments that were endorsed on January 6, 2013 by the Group of Governors and Heads of Supervision (the "*GHOS*"), the oversight body of the Basel Committee.[2]

Along with the Net Stable Funding Ratio (the "*NSFR*") and certain related metrics (or "*monitoring tools*") that aid supervisors in assessing the liquidity risk of a bank, the LCR is a key component of the Basel III liquidity framework. The Basel III liquidity framework was initially proposed by the Basel Committee in December 2009, supplemented by amendments released in July 2010 and published in December 2010 (the "*2010 liquidity framework*").[3] The LCR is defined under the Basel III liquidity framework as the ratio of the "stock of high-quality liquid assets" to "total net cash outflows over the next 30 calendar days".

The revised LCR standard makes several noteworthy amendments to the LCR as set forth in the 2010 liquidity framework, including:

- The outflow assumptions for several sources of funding have been reduced. For example, the outflow assumption on (i) certain stable retail deposits is reduced from 5% to 3%, (ii) non-operational deposits provided by non-financial corporates, sovereigns, central banks and public sector entities ("*PSEs*") is reduced from 75% to 40% and (iii) committed but unfunded liquidity facilities to non-financial corporates, sovereigns, central banks and PSEs is reduced from 100% to 30%.
- Several outflow assumptions relating to the treatment of collateral have been introduced. For example, the revised LCR standard assigns a 100% outflow assumption to non-segregated collateral that could contractually be recalled by a counterparty because the collateral is in excess of the counterparty's current collateral requirements.
- The operational requirements for high-quality liquid assets have been amended and generally made more robust. For example, the revised LCR standard introduces an express requirement

that the stock of high-quality liquid assets be well diversified within asset classes, with certain limited exceptions.

- There is an increased reliance on external credit ratings that, to the extent the Basel III liquidity framework is implemented in the United States, could not be included in the U.S. federal banking agencies' regulations because of the requirements of Section 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "*Dodd-Frank Act*").[4]
- The LCR will be introduced as a minimum standard as planned on January 1, 2015. However, the LCR will begin at 60% (rather than 100% as initially contemplated) and be phased-in over the next four years in 10% increments, reaching 100% on January 1, 2019.

The revised LCR standard also reaffirms that a bank may use its stock of high-quality liquid assets in times of stress and provides guidance on this use.

Although the LCR amendments have been described as a "weakening" of liquidity requirements, in many respects the revisions appear to track more closely empirical data and in some cases the requirements have been strengthened.

The amendments reflected in the revised LCR standard do not substantively amend the monitoring tools set forth in the Basel III liquidity framework published in December 2010, and do not address the NSFR at all. The press release announcing the GHOS's endorsement of the amendments to the LCR noted that the Basel Committee will "press ahead" with its review of the NSFR over the next two years.

The Board of Governors of the Federal Reserve System (the "*Federal Reserve*") has indicated it is considering, along with the Office of the Comptroller of the Currency (the "*OCC*") and the Federal Deposit Insurance Corporation (the "*FDIC*" and, together with the OCC and the Federal Reserve, the "*federal banking agencies*"), rulemakings that would implement the Basel III liquidity framework in the United States. The federal banking agencies have not yet addressed which U.S. banking organizations will be subject to the Basel III liquidity framework.

BASEL III LIQUIDITY FRAMEWORK

The Basel III liquidity framework has three key components:

- the LCR, which is designed to ensure that a bank maintains an adequate level of unencumbered, high-quality assets that can be converted into cash to meet its liquidity needs for a 30-day time horizon under an acute liquidity stress scenario specified by supervisors;
- the NSFR, which is designed to promote more medium and long-term funding of the assets and activities of banks over a one-year time horizon; and
- a set of common metrics, referred to as "monitoring tools", that the Basel Committee indicates should be considered as the minimum types of information that banks should report to supervisors.

The revised LCR standard amends specific aspects of the LCR. It does not substantively amend the monitoring tools as set forth in the 2010 liquidity framework (although it includes them), and does not address the NSFR at all. As described in the "Background and Summary" section of this memorandum,

the LCR is defined as the ratio of a bank's stock of high-quality liquid assets divided by its total net cash outflows over the next 30 calendar days. When fully phased-in, the ratio must be at least 100% (that is, the stock of high-quality liquid assets must always at least be equal to total net cash outflows). This definition was not changed by the revised LCR standard.

Amendments to the LCR

Changes to the Definition and Treatment of High-Quality Liquid Assets

Although the revised LCR standard did not alter the fundamental approach of the LCR, it did amend the definition of "high-quality liquid asset" in several respects.

"Level 2A" and "Level 2B" Assets

Under the 2010 liquidity framework, the stock of high-quality liquid assets was divided into two categories:

- "Level 1 assets", which generally consist of cash, central bank reserves that can be drawn down in times of stress, and marketable securities representing claims on or guaranteed by sovereigns, central banks, non-central government PSEs, and certain multi-national bodies (subject to several additional criteria); and
- "Level 2 assets", which generally consist of marketable securities issued by 20% risk-weighted sovereigns, central banks and non-central government PSEs (for example, Fannie Mae and Freddie Mac), AA- or higher-rated corporate bonds and covered bonds (in each case, subject to several additional criteria).

Each Level 2 asset was subject to a 15% haircut as applied to its current market value, and Level 2 assets in the aggregate were limited to 40% of the total stock of high-quality liquid assets after haircuts.

Under the revised LCR standard, Level 2 assets are split into two subcategories: Level 2A assets and Level 2B assets. Level 2A assets generally correspond to Level 2 assets under the 2010 liquidity framework (and, like Level 2 assets, are subject to a 15% haircut). However, instead of "corporate bonds" the revised LCR standard refers to "[c]orporate debt securities (including commercial paper)" and thus expressly references commercial paper. In addition, the revised LCR standard amended the rating requirement for corporate bonds and covered bonds. Under the revised LCR standard, corporate debt instruments and covered bonds that are rated by a recognized external credit assessment institution (an "*ECAI*") must have a long-term credit rating of at least AA-, or in the absence of a long term rating, a short-term rating equivalent in quality to the long-term rating. The 2010 liquidity framework required a rating of AA- for such instruments but did not specify whether the rating needed to be long- or short-term.

Unlike the 2010 liquidity framework, the revised LCR standard expressly provides for the use of local rating scales (as opposed to international ratings) of a supervisor-approved ECAI meeting the eligibility criteria outlined in the Basel II[5] capital framework,[6] provided that the corporate debt security or covered bond are held by a bank for local currency liquidity needs arising from its operations in that local jurisdiction, thereby potentially broadening the range of instruments that will qualify as Level 2A assets.

Level 2B assets under the revised LCR standard, which may be included in Level 2 assets at the discretion of applicable national authorities, comprise:

- residential mortgage backed securities (subject to a 25% haircut) provided that, among other criteria, the securities are not issued by, and the underlying assets have not been originated by the bank or its affiliates and have a long-term credit rating from a recognized ECAI of AA or higher or, in the absence of a long-term rating, a short-term rating equivalent in quality to the long-term rating, the underlying asset pool is restricted to residential mortgages and cannot contain structured products, the underlying mortgages are "full recourse"[7] loans and have a maximum loan-to-value ratio of 80% on average at issuance and the securitizations are subject to "risk retention" regulations that require issuers to retain an interest in the securitized assets. The "risk retention" requirement would appear to preclude residential mortgage backed securities issued before the effective date of applicable risk retention requirements from being treated as Level 2B assets;[8]
- corporate debt securities including commercial paper (subject to a 50% haircut), provided that, among other criteria, the securities are not issued by a financial institution or its affiliates; have a long-term credit rating from a recognized ECAI between A+ and BBB- or in the absence of a long-term rating an equivalent in quality short-term rating, or do not have a credit assessment by a recognized ECAI and are internally rated as having a probability of default corresponding to a credit rating of between A+ and BBB-; and have a "proven record as a reliable source of liquidity in the markets" even under stressed conditions (that is, the price of the debt security cannot have fallen by more than 20% or its haircut could not have increased over a 30-day period more than 20% during a relevant period of significant liquidity stress); and
- common equity shares (subject to a 50% haircut) provided that, among other criteria, the shares (x) are (i) not issued by a financial institution or its affiliate, (ii) exchange traded and centrally cleared and (iii) a constituent of the major stock index in the home jurisdiction or where the liquidity risk is taken (as determined by the supervisor in the jurisdiction where the index is located), (y) have a "proven record as a reliable source of liquidity in the markets" even during stressed market conditions (that is, the share price cannot have fallen more than 40% or its haircut could not have increased by more than 40% over a 30-day period during a relevant period of significant liquidity stress) and (z) are denominated in the domestic currency of a bank's home jurisdiction or in the currency of the jurisdiction where a bank's liquidity risk is taken.[9]

Level 2A assets, together with any permissible Level 2B assets, cannot represent more than 40% of the overall stock of high-quality liquid assets (after applicable haircuts). In addition, Level 2B assets cannot exceed more than 15% of the overall stock of an institution's high-quality liquid assets (after applicable haircuts).

The revised LCR standard's addition of Level 2B assets to the stock high-quality liquid assets is partially responsive to industry concerns that the scope of the definition of high-quality liquid assets both as initially proposed and as subsequently amended was unduly narrow. Although the Basel Committee has expanded the assets that qualify as high-quality liquid assets from the initial definition of that term, the Basel Committee has resisted expanding the definition to include, as some commenters had urged, Federal Home Loan Bank advances, investment grade municipal obligations and gold. It remains to be seen whether the federal banking agencies will, when implementing the LCR, recognize any additional classes of assets in the definition of high-quality liquid asset.

Level 1 Assets

The definition of Level 1 assets in the revised LCR standard references "coins and banknotes" instead of "cash" (which was used in the 2010 liquidity framework). It is possible that this change was to clarify that "cash" should not be interpreted to mean items recorded as "cash and cash equivalents" under generally accepted accounting principles ("*GAAP*"), a category that includes assets such as currency on hand, demand deposits and other similar accounts, money market funds, treasury bills and commercial paper. Because a major GAAP cash equivalent for most banks is likely central bank reserves, it is not clear how much of an impact this change will have.

Treatment of High-Quality Liquid Assets in Subsidiaries

Like the 2010 liquidity framework, the revised LCR standard provides that its standards should be applied on a consolidated basis to internationally active banks, but may also be applied to, among other entities, a subsidiary or group of subsidiaries of such banks. In the event the LCR's requirements apply to a subsidiary or group of subsidiaries of an internationally active bank, high-quality liquid assets of the subsidiary or group may only be included in the stock of high-quality liquid assets at the consolidated level if the related net outflows of the subsidiary or group are also reflected. In addition, any surplus of high-quality liquid assets held in a subsidiary or group can only be consolidated if those assets would be "freely available" to the consolidated entity in times of stress. As to the meaning of "freely available", the revised LCR standard clarifies that assets may not be "freely available" to the consolidated entity because of "regulatory, legal, tax, accounting or other impediments", a clarification that was not included in the 2010 liquidity framework.[10] The application of the "freely available" requirement to any surplus of high-quality liquid assets held in subsidiary banks of bank holding companies is uncertain in light of customary limitations on the ability of banks to transfer assets to their affiliates (for example, the limitations on the ability of subsidiary banks to declare and pay dividends to their holding companies under applicable banking laws and restrictions on transactions with affiliates under Sections 23A and 23B of the Federal Reserve Act).

Additional Guidance Regarding Use of the Stock of High-Quality Liquid Assets

The revised LCR standard reaffirms that a bank may use its stock of high-quality liquid assets during a period of financial stress[11] and provides broad guidance to supervisors regarding a bank's use of its high-quality liquid assets. This guidance was not included in the 2010 liquidity framework. In particular, the revised LCR standard provides that during a period of financial stress, banks may use their stock of high-quality liquid assets (and thereby allow their LCRs to fall below 100%), and that banks may use their stock of high-quality liquid assets in both "idiosyncratic and systemic stress events", thus perhaps suggesting that a bank may not necessarily itself have to be experiencing a liquidity crisis in order for it to use its stock of high-quality liquid assets (for example, using the assets to provide liquidity to the financial system in response to a systemic crisis).[12]

In addition, the revised LCR standard advises supervisors, when responding to a bank's use of its high-quality liquid assets, to, among other things:

- account for prevailing macrofinancial conditions as well as forward looking macroeconomic and financial conditions and consider whether an action could be procyclical;
- allow for differentiated responses to a reported LCR below 100% (which responses should be proportionate with the "drivers, magnitude, duration and frequency of the reported shortfall");
- account for the magnitude, duration and frequency of the reported decline of the bank's stock of high-quality liquid assets; and
- assess a number of firm- and market-specific factors in determining the appropriate response as well as other considerations related to both domestic and global frameworks and conditions, including, for example, the reason the LCR fell below 100%, the extent to which the reported decline is due to a firm-specific or market-wide shock, the bank's overall health and risk profile, the potential for "contagion" to the financial system and additional restricted flow of credit or reduced market liquidity as a result of actions to maintain an LCR of 100% and the availability of other sources of contingent funding.

In the event its LCR falls below 100%, a bank should provide an assessment of its liquidity position, including the factors that contributed to its LCR falling below 100%, the measures that have been and will be taken and the expectations on the potential length of the situation. "Enhanced reporting" commensurate with the duration of the shortfall is also expected.

In the context of discussing the supervisory response to a reported LCR below 100%, the revised LCR standard references the requirement in the Basel Committee publication titled *Principles for Sound Liquidity Risk Management and Supervision* (the "*Sound Principles*") that banks develop a Contingency Funding Plan ("*CFP*") that clearly sets out strategies for addressing liquidity shortfalls, both firm-specific and market-wide situations of stress.[13] Under the Sound Principles, a bank's CFP should be closely integrated with its ongoing analysis of liquidity risk and with the results of the scenarios and assumptions used in stress tests, and contain clear policies and procedures that will enable the bank's management to make timely and well-informed decisions, execute contingency measures and, communicate with supervisors, market participants, clients and various stakeholders.[14] The CFP required under the Sound Principles is broadly consistent with the CFP requirement in the Federal Reserve's proposed rulemaking published in the Federal Register in January 2012 implementing the enhanced prudential standards (including liquidity requirements) mandated by Sections 165 and 166 of the Dodd-Frank Act (the "*Proposed 165/166 Rules*").[15] An institution subject to the liquidity requirements in the Proposed 165/166 Rule is required to have a CFP, which in turn is required to include a quantitative assessment incorporating information generated by the liquidity stress testing required under the Proposed 165/166 Rules, include an "event management process" setting out the procedures for managing liquidity during identified liquidity stress events (including a mechanism ensuring effective reporting and communication within the relevant company and with relevant supervisors, counterparties and stakeholders), include procedures for monitoring emerging liquidity stress events and provide for periodic testing of the components of the CFP to assess its reliability during stress events.[16]

Operational Requirements

The revised LCR standard, like the 2010 liquidity framework, subjects assets in the stock of high-quality liquid assets to certain operational requirements (including the requirement that an asset be "unencumbered" in order to be included in the numerator of the ratio). The revised LCR standard, however, clarifies or expands on those standards in several instances:

- As under the 2010 liquidity framework, the revised LCR standard requires a bank to keep the stock of high-quality liquid assets under the control of the function charged with managing liquidity at the bank (for example, the treasury function). However, it clarifies that "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 throughout the 30-day stress period without directly conflicting with a stated business or risk management strategy. The revised LCR standard cites as an example of such a conflict an asset whose sale would remove a hedge that would create an open risk position in excess of internal limits. Such an asset would have to be excluded from the stock of high-quality liquid assets.
- Under the 2010 liquidity framework, "unencumbered" meant "not pledged (either explicitly or implicitly) to secure, collaterali[z]e or credit-enhance any transaction". This definition is expanded under the revised LCR standard, which defines the term to mean "free of legal, regulatory, contractual or other restrictions on the ability of the bank to liquidate, sell, transfer, or assign the asset". It also provides that, as under the 2010 liquidity framework, an asset must not be "pledged (either explicitly or implicitly) to secure, collaterali[z]e or credit-enhance any transaction" but adds that the asset may not "be designated to cover operational costs (such as rents and salaries)". Whether these changes expand the definition will depend ultimately on how supervisors interpret them. If interpreted broadly, these changes could substantially expand the definition (for example, any sale of an instrument that is a "security" generally would be subject to securities laws and thus the ability of a bank to make such a sale could, broadly, be said to be subject to a "legal restriction").[17]
- A bank is required under the revised LCR standard to have a policy in place identifying legal entities, geographical locations, currencies and specific custodial or bank accounts where high-quality liquid assets are held.
- The revised LCR standard introduces an "operational capability" requirement, whereby a bank cannot include an asset in the stock of high-quality liquid assets unless it has the operational capability to monetize assets during the stress period. "Operational capability" for these purposes requires the bank to have procedures and appropriate systems in place to monetize an asset at any time in the standard settlement period for the asset class in the relevant jurisdiction.
- Under the revised LCR standard, a bank is required to monetize periodically a representative portion of its high-quality liquid assets through a repo or outright sale. This requirement is similar to a requirement in the Proposed 165/166 Rules, which provides that a company subject to those rules must periodically test its access to alternative funding sources in order to determine whether those funding sources will be readily available when needed. Some commenters had expressed concern with this provision on the grounds that it could be interpreted to require companies, for example, to draw-down on liquidity lines or access other funding sources, such as the Federal Reserve discount window. Financial markets that became aware of these monetization activities might not understand that a particular action was taken in response to this requirement and might assume that the monetization was indicative of liquidity stress, possibly resulting in an unnecessary and inappropriate response by market participants that would contribute to financial instability. In light of its similarity to the foregoing requirement under the Proposed 165/166 Rules, the revised LCR standard's monetization requirement could prompt similar concerns.
- The revised LCR standard adds an express requirement that the stock of high-quality liquid assets be well-diversified within asset classes (other than for sovereign debt of the bank's home

jurisdiction or from the jurisdiction in which the bank operates, central bank reserves, central bank debt securities and cash), and requires banks to have policies and limits in place in order to avoid concentration of asset types, issue and issuer types and currency within asset classes.[18]

Amendments to Run-Off Factors

As under the 2010 liquidity framework, the denominator of the LCR under the revised LCR standard is calculated as the excess of cash outflows over the next 30 calendar days minus cash inflows over the next 30 calendar days, in each case, calculated and determined pursuant to detailed and specific requirements. The requirements include specified "*run-off factors*" or "*outflow assumptions*" for various types of deposits and other liabilities. Commenters on the Basel III liquidity framework had expressed concern that many of the run-off factors for deposits and credit and liquidity facilities were overly conservative and not aligned with observed run-off rates during the recent financial crisis. The revised LCR standard addresses these comments to some extent by reducing several run-off factors, making them generally less conservative. Commenters had also expressed concern with the asymmetrical aspects of the LCR, which required a bank to assume it would fully fund credit and liquidity facilities but would not be able to draw on credit and liquidity facilities. The revised LCR standard partially addresses this concern by reducing, as described below, the outflow assumptions related to draws on credit and liquidity facilities (where the bank is the lender) but continues to require banks to assume that they cannot draw (as borrowers) on credit and liquidity facilities during a crisis, an assumption thought by many commenters to be unduly conservative. In addition to adjusting the run-off factors for various deposits and liabilities, the revised LCR standard also provides additional guidance on certain aspects of the outflow calculation as described below.

- ***Stable Retail Deposits*:** The revised LCR standard retains the 2010 liquidity framework's 5% and higher run-off rate for "stable retail deposits" (that is, the amount of retail deposits that are fully insured by an effective deposit insurance scheme or by a public guarantee providing equivalent protection)[19] where the depositors have other established relationships with the bank that make withdrawal highly unlikely and the deposits are in transactions accounts (for example, accounts where salaries are automatically deposited). Unlike the 2010 liquidity framework, however, the revised LCR standard permits (but does not require) a national regulator to apply a 3% run off factor to stable retail deposits that satisfy the foregoing requirements provided the following additional requirements are satisfied:
    - The jurisdiction's deposit insurance scheme must:
        - be based on a system of prefunding via the periodic collection of levies on banks with insured deposits;
        - have adequate means of ensuring ready access to additional funding in the event of a large call on its reserves (for example, an explicit and legally binding guarantee from the government, or a standing authority to borrow from the government); and
        - access to insured deposits is available to depositors in a short period once the deposit insurance scheme is triggered.[20]
    - With respect to stable retail deposits with deposit insurance arrangements that satisfy the above deposit insurance requirements, the jurisdiction must be able to provide evidence of run-off rates below 3% during any periods of stress experienced that are consistent with the LCR's conditions.

- ***Non-Operational Deposits:*** Unsecured wholesale funding provided by non-financial corporate customers (other than small business customers), sovereigns, central banks, multilateral development banks and PSEs without operational relationships can receive a 20% run-off factor under the revised LCR standard if the entire amount of the deposit is fully covered by an effective deposit insurance scheme or by a public guarantee that provides equivalent protection, and receive a 40% run-off factor otherwise. Under the 2010 liquidity framework, these deposits received a run-off factor of 75%, whether or not they were fully covered by an effective deposit insurance scheme or equivalent public guarantee.
- ***Liquidity and Credit Facilities:*** Under the revised LCR standard, the outflow assumption for:
    - committed but unfunded liquidity facilities to non-financial corporates, sovereigns, central banks, PSEs and multilateral development banks is 30% (compared with 100% under the 2010 liquidity framework);
    - committed but unfunded credit and liquidity facilities extended to banks subject to prudential supervision is 40%. The 2010 liquidity framework treated these credit and liquidity facilities as "committed credit and liquidity facilities to other legal entities" and assigned them a 100% outflow assumption; and
    - committed but unfunded credit facilities to other financial institutions including securities firms, insurance companies, fiduciaries, and beneficiaries is 40%. Committed but unfunded liquidity facilities to these institutions are assigned an outflow assumption of 100% under the revised LCR standard. Credit and liquidity facilities to such institutions under the 2010 liquidity framework received an outflow assumption of 100%.
- ***Trade Finance:*** Under the 2010 liquidity framework, trade finance instruments were treated as "other contingent funding obligations" and the run-off rate was subject to national discretion. The revised LCR standard permits national authorities to apply a "relatively low" run-off rate (for example, 5% or less) to contingent funding obligations arising from trade finance instruments. "Trade finance instruments", for these purposes, consist of trade-related obligations "directly underpinned" by the movement of goods or the provision of services, such as:
    - documentary trade letters of credit, documentary and clean collection, import bills, and export bills; and
    - guarantees directly related to trade finance obligations, such as shipping guarantees.

Additional Changes to the Final Basel III Framework

Other noteworthy changes made by the revised LCR standard include:

- ***Phase-In:*** As under the 2010 liquidity framework, the LCR will be introduced on January 1, 2015. However, the minimum LCR requirement will begin at 60% (rather than 100% as initially contemplated) and be phased-in over the next four years in 10% increments, reaching 100% on January 1, 2019 (as illustrated in the below table):

LCR Phase-In

	January 1, 2015	January 1, 2016	January 1, 2017	January 1, 2018	January 1, 2019
Minimum LCR	60%	70%	80%	90%	100%

- ***Treatment of Collateral:*** The revised LCR standard addresses several liquidity risks (not expressly addressed in the 2010 liquidity framework) generally related to collateral substitution and the treatment of excess collateral. In particular, the revised LCR standard assigns a 100% outflow assumption to:
    - non-segregated collateral that could contractually be recalled by a counterparty because the collateral is in excess of the counterparty's current collateral requirements;

    - collateral that is contractually due but where the counterparty has not yet demanded the posting of such collateral; and
    - the amount of high-quality liquid assets collateral that can be substituted for non-high-quality liquid assets without the bank's consent that have been received to secure transactions that have not been segregated.
- ***Market Valuation Changes:*** Under the 2010 liquidity framework, the outflow assumption for liquidity needs related to market valuation changes on derivative or other transactions was left to national discretion. The revised LCR standard requires that any outflow generated by increased needs related to market valuation changes should be included in the LCR calculated by identifying the largest absolute net 30-day collateral flow realized during the preceding 24 months, and provides that supervisors may adjust the treatment flexibly according to circumstances.
- ***Master Netting Agreements:*** The 2010 liquidity framework allowed banks to determine cash outflows for derivatives on a net basis. The revised LCR standard permits banks to determine cash outflows for derivatives on a net basis, but also expressly requires there to be a valid master netting agreement.
- ***Derivative Payment Collateralized by High-Quality Liquid Assets:*** If a derivative payment is collateralized by high-quality liquid assets, cash outflows are required to be calculated net of any corresponding cash or collateral inflows arising from contractual obligations for cash or collateral to be provided to the bank if the bank is legally entitled and operationally capable to re-use the collateral in new cash raising transactions once the collateral is received. The 2010 liquidity framework did not specifically address this scenario. The Basel Committee notes that this treatment is consistent with the principle that banks should not double count liquidity inflows and outflows.[21]
- ***Central Bank Reserves:*** The revised LCR standard clarifies that central bank reserves, for purposes of Level 1 assets, include "required reserves", which include banks' overnight deposits with the central bank, and term deposits with the central bank that: (i) are explicitly and contractually repayable on notice from the depositing bank or (ii) constitute a loan against which the bank can borrow on a term basis or on an overnight but automatically renewable basis (only where the bank has an existing deposit with the relevant central bank). Other term deposits with central banks are not eligible for the stock of high-quality liquid assets; however, if the term expires within 30 days, the term deposit could be considered as an inflow.[22]
- ***Customer Cash Arising From Prime Brokerage Services:*** The revised LCR standard provides that customer cash balances arising from the provision of prime brokerage services (for example, clearing, settlement and custody, securities lending, capital introduction and risk analytics) should be considered separate from any required segregated balances related to client protection regimes imposed by national regulations, and should not be netted against other customer exposures included in this standard. The offsetting balances held in segregated accounts are treated as inflows and excluded from the stock of high-quality liquid assets.
- ***Expanded Discretion for National Regulators:*** In a number of instances (several of which are also discussed above), the revised LCR standard expands the discretion of national regulators. For example:
    - National regulators are able to assign a 3% and higher rate to stable retail deposits, provided various requirements are met.
    - Supervisors are permitted to work with banks to determine an agreed methodology for capturing the non-contractual funding obligations related to potential liquidity draws from joint ventures or minority investments that are not consolidated where there is an expectation that the bank will be the main liquidity provider when the entity is in need of liquidity.
    - Supervisors are permitted to adjust "flexibly according to circumstances" the outflow treatment of increased liquidity needs related to market valuation changes.

- National regulators are permitted to assign a "relatively low" run-off rate to trade finance instruments.

Relationship to U.S. Liquidity Regulation

A "*liquidity buffer*" similar to the LCR forms a part of the liquidity regime the Federal Reserve is in the process of instituting in the United States. In December 2011, the Federal Reserve issued for public comment the Proposed 165/166 Rules, which include rules to address the enhanced liquidity requirements required by Section 165(b)(1)(A)(ii) of the Dodd-Frank Act for "*covered companies*" (that is, bank holding companies with $50 billion or more in total consolidated assets and nonbank financial companies designated as systemically important by the Financial Stability Oversight Council).

The Federal Reserve stated it intends to institute a liquidity regime for covered companies in stages. In the first stage, covered companies would be subject to enhanced liquidity standards under the final version of the Proposed 165/166 Rules. In the second stage, the Federal Reserve intends to subject covered companies to specific quantitative liquidity requirements derived from, or consistent with, the Basel III liquidity framework (including the LCR), and has indicated it is considering along with the OCC and the FDIC, one or more joint rulemakings that would implement the Basel III liquidity framework in the United States.[23]

The liquidity framework proposed by the Federal Reserve addresses several aspects of liquidity management, and includes detailed corporate governance provisions regarding, for example, the responsibilities of the board of directors, its risk committee and senior management as to establishing a covered company's "liquidity risk tolerance", approving the liquidity costs, benefits and risks of each significant new business line and product before the business line or product is implemented and reviewing and approving the covered company's CFP. It also includes requirements for covered companies to:

- produce comprehensive cash flow projections and identify and quantify cash flow mismatches. Although the Proposed 165/166 Rules impose cash flow projections and stress testing requirements, they do not follow the approach in the Basel III liquidity framework of specified uniform run-off factors and assumed draw-down rates for purposes of calculating net cash outflows;
- conduct regular stress tests of cash flow projections and use those stress tests in determining the size of their liquidity buffers;
- maintain a liquidity buffer of "highly liquid assets" that are "unencumbered". The liquidity buffer must be sufficient to meet projected net cash outflows and the projected loss or impairment of existing funding sources for 30 days over a range of liquidity stress scenarios, using the liquidity stress testing referenced above;
  - The term "highly liquid assets" is defined to mean cash, securities issued or guaranteed by the U.S. government, a U.S. government agency or a U.S. government-sponsored agency, or any other asset that the covered company demonstrates to the satisfaction of the Federal Reserve has low credit and low market risk, is traded in an active secondary two-way market that has observable prices and meets other standards, and is of a type that investors historically purchased in periods of financial market distress during which market liquidity was

impaired. This definition does not align with the definition of high-quality liquid assets in the revised LCR standard in a couple respects:

    - It does not include securities of foreign sovereigns or PSEs, except possibly pursuant to the third prong of the test; and
    - It does not differentiate between different types of highly liquid assets as a proportion of the total amount of highly liquid assets (whereas the LCR divides liquid assets into "Level 1", "Level 2A" and "Level 2B" assets, with Level 2A and 2B assets being limited in the aggregate to 40% of total liquid assets), and thus Fannie Mae debt securities could be included without limit in a covered company's "highly liquid assets";

  - The Proposed 165/166 Rules define the term "unencumbered" broadly to mean that the asset is not pledged in any respect, subject to legal or contractual restrictions on liquidation or transfer, or designated as a hedge in a trading position, which is broadly consistent with the definition of that term in the revised LCR standard. The Basel III liquidity framework (including the revised LCR standard) provides that short-term (30-day or less) repos and reverse repos should be assumed to be unwound for purposes of LCR calculations. The proposed liquidity buffer, in contrast, does not assume that they are unwound;

- establish and maintain a CFP setting out the covered company's strategies for addressing liquidity needs during liquidity stress events. As discussed above, the CFP required under the Proposed 165/166 Rules is broadly consistent with the CFP requirement in the Sound Principles publication, which is referenced by the Basel Committee in the revised LCR standard;
- establish and maintain limits on potential source of liquidity risk; and
- monitor liquidity risk related to collateral positions, liquidity risks across the enterprise and intraday liquidity positions.

To date, none of the federal banking agencies has expressly addressed whether the Basel III liquidity framework will apply to all U.S. banking organizations or only to larger banking organizations.

CONCLUDING OBSERVATIONS

It remains to be seen whether further amendments to the LCR will be made by the Basel Committee prior to its introduction as a minimum standard in 2015. The press release announcing the GHOS's endorsement of the amendments to the LCR noted that the Basel Committee will continue to develop disclosure requirements for bank liquidity and funding profiles and analyze the interaction between the LCR and the provision of central bank facilities. It thus remains possible that amendments addressing these aspects of the LCR will be implemented at some time before the LCR is introduced as a minimum standard in 2015. As to the LCR's implementation in the U.S., it is still uncertain to which banking organizations the LCR will ultimately apply, and which creditworthiness standard will replace the LCR's use of credit ratings as criteria for Level 2A and Level 2B eligible assets in light of the Dodd-Frank Act's prohibition on the use of credit ratings.[24]

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ENDNOTES

1 *See* Basel Committee, *Basel III: The Liquidity Coverage Ratio and Liquidity Risk Monitoring Tools* (Jan. 2013) (the "*Basel III LCR*").

2 For information regarding the summary of the amendments to the LCR that was published on January 6, 2013, see Sullivan & Cromwell LLP's memorandum to clients titled *Basel III Liquidity Framework: Basel Committee Announces Summary of Changes to the Basel III Liquidity Coverage Ratio,* dated January 7, 2013.

3 The 2010 liquidity framework is set forth in a document published by the Basel Committee on December 16, 2010 and titled *Basel III: International Framework for Liquidity Risk Measurement, Standards and Monitoring*. For additional information regarding the 2010 liquidity framework, see Sullivan & Cromwell LLP's memorandum to clients titled *Basel III Capital and Liquidity Framework: Basel Committee Issues Final Revisions to International Regulation of Bank Capital and Liquidity*, dated December 31, 2010.

4 Section 939A of the Dodd-Frank Act generally requires all federal agencies to remove references to, and requirements of reliance on, credit ratings from their regulations and to replace them with appropriate alternatives for evaluating creditworthiness.

5 "*Basel II*" generally refers to the Basel Committee's comprehensive new accord titled *International Convergence of Capital Measurement and Capital Standards – A Revised Framework*, published in June 2006.

6 Basel II, ¶ 91. These eligibility criteria include objectivity, independence, international access/ transparency, disclosure of assessment methodologies, sufficient resources to carry out high quality credit assessments and credibility. *Id.*

7 For these purposes, "full recourse" means that "in the case of foreclosure the mortgage owner remains liable for any shortfall in sales proceeds from the property". Basel III LCR, ¶ 54(a). This could present a real issue with respect to mortgages in states such as California where applicable law does not always provide for such a remedy.

8 In the United States, the risk retention requirements applicable to issuers of asset-backed securities under Section 941(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act have been proposed but not yet adopted. *See* Department of the Treasury *et al.*, *Credit Risk Retention*, 76 F.R. 24090 (Apr. 29, 2011).

9 The criterion in clause (z) above may have been included as a criterion for common equity instead of corporate debt securities in error. That criterion would at least facially make sense for corporate debt, because corporate debt instruments specify the currency in which payments will be made. In contrast, shares of common stock would not typically include such a limitation on either dividends paid on those shares or the type of consideration that may be received in exchange for them.

10 Basel III LCR, ¶ 34.

11 This confirms a position initially announced by the GHOS in a January 8, 2012 press release.

12 Basel III LCR, ¶ 17.

13 As to the Sound Principles, the Basel Committee notes that it will continue to monitor the implementation of the guidance in the Sound Principles to "ensure that banks adhere to these fundamental principles". *Id.*, ¶ 3.

14 Basel Committee, *Principles for Sound Liquidity Risk Management and Supervision*, ¶¶ 110-122 (Sept. 2008).

15 *See* Federal Reserve System, *Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies*, 77 F.R. 594 (Jan. 5, 2012).

ENDNOTES (CONTINUED)

16 For information regarding the Proposed 165/166 Rules, see Sullivan & Cromwell LLP's memorandum to clients titled *Systemically Important Financial Companies: Federal Reserve Issues Proposed Rules Implementing Enhanced Prudential Supervision Regime*, dated December 22, 2011.

17 Such an interpretation would likely render the definition unworkable.

18 Basel III LCR, ¶ 44.

19 *Id.*, ¶ 75. Under the 2010 liquidity framework, stable deposits are the amount of the deposits that are "fully covered" (instead of "fully insured") by an effective deposit insurance scheme or by a public guarantee that provides equivalent protection. Basel Committee, *Basel III: International Framework for Liquidity Risk Measurement, Standards and Monitoring,* ¶ 56 (Dec. 2010). "Fully covered" was not a defined term under the 2010 liquidity framework. In contrast, the revised LCR standard has provided a definition of "fully insured", defining the term to mean 100% of the deposit amount, up to the deposit insurance limit, is covered by an effective deposit insurance scheme. Deposit balances up to the deposit insurance limit can be treated as "fully insured" although any amount in excess of the deposit insurance limit is to be treated as "less stable". However, if the deposit insurance scheme only covered a percentage of the funds (for example, 90% of the deposit amount up to a limit of 100) then the entire 150 deposit would be less stable. Basel III LCR, ¶ 75 fn. 34. This definition of "fully covered" is consistent with guidance provided in a set of answers to frequently asked questions published by the Basel Committee in July 2011. *See* Basel Committee, *Basel III Framework for Liquidity – Frequently Asked Questions*, ¶ 75 (July 2011).

20 The Basel Committee plans to review these criteria pending the completion of an update of the "Core Principles" of the International Association of Deposit Insurers to reflect "leading practices" better. *See* Basel III LCR, ¶ 78 fn. 35.

21 *Id.*, ¶ 117.

22 *Id.*, ¶ 50 n. 12.

23 77 F.R. 595, 605 (Jan. 5, 2012).

24 *See supra* note 4.

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