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Regulatory brief

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Liquidity coverage ratio: Another brick in the wall

Overview

On October 24, 2013, the Federal Reserve Board of Governors ("Fed") approved an interagency proposal for the US version of the Basel Committee on Banking Supervision's ("BCBS") Liquidity Coverage Ratio ("LCR"). The LCR measures liquidity stress over a short-term period, and would apply to US banking organizations and certain other systemically important financial institutions. The comment period for the proposal is scheduled to close by January 31, 2014.

The LCR forms one of the key components of the Basel III reform package, which also includes:

- Revised capital standards, which have been largely completed in the US. Only the Supplementary Leverage Ratio for larger firms remains in proposed form, but it will likely be finalized by year-end 2013.[1]
- The Net Stable Funding Ratio ("NSFR"), a longer-term liquidity measure over a one-year time frame, is designed to measure institutions' structural funding characteristics and to restrain over-reliance on shorter-term wholesale borrowing. This separate measure remains under review by the BCBS with the possibility of finalization in 2013, followed by a US proposed rule in mid-2014.

The US LCR proposal came out significantly tougher than BCBS's version, especially for the larger bank holding companies ("Large BHCs")[2] – likely beyond the eight US firms identified as G-SIBs. First, the US proposal excludes key items from the definition of high quality liquid assets ("HQLA") such as private label mortgage debt (impacting the LCR's numerator), while treating GSE-issued debt less favorably than expected (rendering GSE debt a "Level 2A" asset rather than "Level 1") despite their deep and liquid market. The restriction of these items may result in an approximately 8% reduction in HQLA stock on average for the largest US institutions as compared to BCBS's version of the LCR (discussed below).

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[1] See PwC's *Financial Services Regulatory Briefs, Basel III capital rules finalized by Federal Reserve: but much more to come for the big banks* (July 2013) and *Heightened leverage ratio: US regulators unveil next act for regulating large banks* (July 2013).

[2] The US LCR according to the proposal's text applies to "internationally active banking organizations," which it defines as banking organizations with "$250 billion or more in total assets *or* $10 billion or more in on-balance sheet foreign exposure [*emphasis added*]."

Second, the US proposal introduced a stricter methodology for calculating net cash outflows for Large BHCs (impacting the LCR's denominator), by calculating it based on the "peak" net cumulative amount and applying a daily limit to the amount of outflows that can be offset by inflows (both discussed in more detail below). This change is particularly significant for managing potential mismatches caused by intra-month contractual cash outflows (e.g., processing of customer benefit payments).

Challenges such as these must be met by January 1, 2017 (rather than 2019 under the BCBS's version) and are formalized for the Large BHCs in the US LCR's new tiered structure:

- Large BHCs, and their subsidiary banks with over $10 billion in assets, would be required to report to supervisors their full conformance to the framework.
- Regional firms (those with between $50 and $250 billion in assets) would be subject to a "modified" LCR at the BHC level only.
- Smaller BHCs, those under $50 billion, would remain subject to the prevailing qualitative supervisory framework (addressed under previous guidance).

Following years of development, the US LCR proposal represents only the first step in formalizing the US's liquidity regulatory regime. The LCR's quantitative measures will supplement the qualitative requirements for liquidity risk management for firms covered by the Enhanced Prudential Standards ("EPS") of Section 165 of the Dodd-Frank Act ("DFA").[3] However, about 75 questions for public comment are included within the LCR proposal, nearly reaching the number of questions posed in the entire EPS proposal. The number and scope of these questions indicate that the door remains slightly open for discussion of product/business-specific issues. However, it is unclear to what extent US supervisors will be inclined to diverge further from the BCBS approach.

In the Fed's meeting at which the LCR proposed rule was released, Fed officials indicated that the proposal is tailored to the systemic footprint of US banking firms and is consistent with the "tailored application" provision of DFA. This provision allows the Fed to differentiate prudential standards among companies by taking into consideration their capital structure, riskiness, complexity, and other factors.

[3] The EPS applies to those firms with over $50 billion in assets and remains in proposed form. We expect it will be finalized around the end of this year. See PwC's *Financial Services Regulatory Brief, Basel & prudential standards: US moving faster than world* (August 2013).

The price of liquidity and consistent access to qualifying assets were among the other notable aspects of the public meeting, albeit briefly discussed. Concurrent with submitting public comments to regulators on these issues, management will need to assess:

- The impact on leverage capital requirements as liquid asset holdings increase.
- The consequences to profitability as interest rate spreads compress (due to a shift to better rated HQLAs) and to managing asset-liability mismatches.
- The knock-on effects to business line strategy, including the pricing and delivery of banking products and services (e.g., secured deposits and compensating balances).

Lastly, the proposal makes two notable distinctions regarding the firms it impacts: (1) it applies to FSOC-designated nonbank financial companies ("NFC"), other than those predominantly engaged in insurance activities (likely due to the appropriateness of LCR components to the inherent liquidity risks faced by these firms),[4] and (2) it excludes federal branches and agencies of foreign banks operating in the US. It is unclear how the proposed rule will apply to intermediate holding companies ("IHC") of foreign banking organizations ("FBO"), but we expect clarification once the EPS is finalized.[5]

This **Financial Services Regulatory Brief** (a) analyzes the key elements of the US's LCR proposal drawing distinctions relative to the BCBS version, (b) assesses the impact on HQLA stock between the two versions, (c) explains the LCR in the context of broader US prudential reforms, and (d) suggests actions firms should be taking now.

Key US LCR elements

Although Fed officials were clear to endorse the improvements implemented by the BCBS in its revision to the original LCR proposal from 2010,[6] the proposal advanced by US regulators takes a much stronger approach to fortifying banks' short-term funding profiles. The following (in addition to the detail provided

[4] For a discussion of the EPS's potential application to insurance firms, see PwC's *Financial Services Regulatory Brief, Nonbank SIFIs: FSOC proposes initial designations – more names to follow* (June 2013).

[5] See PwC's *Financial Services Regulatory Brief, Foreign banks: Hope is not a strategy – time to act* (July 2013).

[6] For a discussion of BCBS's revised version of the LCR, see PwC's *Financial Services Regulatory Brief, Basel III Liquidity Regime: more practical but not yet workable* (January 2013).

in the **Appendix**) identifies the US LCR's core elements and its important distinctions from BCBS's revised version:

- Firms would be required to maintain an LCR of 100% under both proposals, i.e., the ratio of HQLA to net cash outflows over a defined period must be at least 1 to 1.
- The parameters for determining net cash outflows are defined within the proposal as follows:
  - For Large BHCs (and their subsidiary banks over $10 billion), the defined period would be 30 days; however, the net cash outflow amount would be determined based on the *peak* cumulative amount within the 30-day period. This use of the highest cumulative amount of net outflows is distinctly more conservative than the BCBS version which measures the cumulative net cash outflow at the *end of* the 30-day period.[7]
  - For covered BHCs over $50 billion, the "modified" LCR, under the US proposal, measures the cumulative net cash outflows at the end of a 21-day period. The net cash outflow parameters are 70% of those applicable to the larger institutions and do not include the requirement to calculate the peak cumulative outflow.
  - For both sets of firms, the US proposal will dramatically re-shape internal reporting and monitoring of liquidity exposures. Firms will need to address both the requirements under the proposal as well as additional reporting demands of supervisors. In addition, supervisors will require firms to submit a remediation plan if the LCR falls below 100% for three consecutive days or longer.
- The transition period applicable to both groups is the same and is significantly accelerated relative to the BCBS version. US firms must meet an 80% LCR by January 1, 2015 which will increase by 10% on each anniversary of that date (thus, firms must meet a 100% LCR by January 1, 2017). We expect the implementation of the 80% LCR to coincide with the implementation date of the EPS for US BHCs and Fed-supervised NFCs. The BCBS version in contrast starts at a 60% level on January 1, 2015 and increases by 10% on each anniversary date. While US regulators noted that the shorter transition period reflects the improved liquidity positions of US institutions, they also noted during the Fed meeting that covered firms face a shortfall of approximately $200 billion of HQLA relative to estimates of firms' requirements to meet the fully phased-in LCR.
- Qualifying assets for HQLA are divided into three specific categories (i.e., Level 1, Level 2A, and Level 2B) similar to the BCBS approach with some distinctions. Across the categories, the combination of Level 2A and 2B assets cannot exceed 40% of HQLA (after haircuts) with 2B assets limited to a maximum of 15% of HQLA.
  - Level 1 represents assets that are highly liquid (generally those risk-weighted at 0% under the Basel III standardized approach for capital) and receive no haircut. Notably, the Fed chose not to include GSE-issued securities in Level 1, despite industry lobbying, on the basis that they are not guaranteed by the full faith and credit of the US government.
  - Level 2A assets generally include assets that would be subject to a 20% risk-weighting under Basel III and includes assets such as GSE-issued and -guaranteed securities. These assets would be subject to a 15% haircut which is similar to the treatment of such securities under the BCBS version.
  - Level 2B assets include corporate debt and equity securities and are subject to a 50% haircut. The BCBS and US version treats equities in a similar manner, but corporate debt under the BCBS version is split between 2A and 2B based on public credit ratings, unlike the US proposal. This treatment of corporate debt securities is the direct impact of DFA's Section 939 (i.e., the removal of references to credit ratings) and further evidences the conservative bias of US regulators' approach to the LCR.
  - While there are trade-offs among the various HQLA categories between the US and BCBS's approach, the distinctions made *within* the US proposal are also significant:
    - Firstly, the implications of the qualitative approach under the EPS seemed ripe for interpretation that GSE debt would be included as a Level 1 asset (based on the security's liquidity and price stability). However, the LCR proposal discards this interpretation in favor of a more punitive approach (by relying on Basel III's risk-weighting of GSE debt at 20%) subordinating GSE debt to Level 2A.

[7] The peak cumulative amount is the highest occurrence of cumulative net cash outflows over the 30-day period, i.e., it is determined by subtracting each day's cumulative inflows from each day's cumulative outflows, and then identifying the *highest* result. This highest amount is then added to the period's one-time non-maturity cash outflows for the total number. In the example provided within the US's proposal, this methodology resulted in a cumulative net cash outflow that was nearly twice as high as the calculation under BCBS's methodology.

- Secondly, the US LCR proposal excludes assets from HQLA such as municipal securities (even though they are risk-weighted at 20% under Basel III like other assets deemed permissible as HQLA) due to liquidity concerns. Furthermore, private label mortgage-backed securities are also excluded from HQLA (although they are included as HQLA under the BCBS version), which is ironic at a time when Congress appears intent on reducing the dominance of GSEs in the mortgage securitization market.

  – Other sources such as Federal Home Loan Bank ("FHLB") credit lines and discount window capacity are also excluded from the HQLA.

- As discussed above, the determination of total net cash outflows is nuanced based on the size of the firm and is different than that under the BCBS approach. Inflows and outflows are specifically defined within the US proposal and are broadly consistent with those under the BCBS approach (although there are some important distinctions):

  – In both the US and BCBS versions, stressed cumulative cash inflows can only offset outflows up to a maximum of 75%; however, the US LCR proposal unlike BCBS's caps this offset by applying it on a daily basis for Large BHCs (and their subsidiaries with greater than $10 billion). A daily offset (as opposed to an aggregate calculation over a period of time) constrains the eligible amount of inflows, making the US proposal much more restrictive than the BCBS's version.

  – For secured short-term funding transactions, the outflow rates under both proposals are based on the HQLA classification of the underlying securities. However, within this classification system, the BCBS's version adjusts the outflow rate for transactions with certain counterparties.

  – For commitments, the proposal identifies outflows ranging from 5% for retail credit facilities to 100% for nonbank financial institutions such as SPEs and conduits. Most corporate credit facilities would generally not exceed an outflow rate of 40% while liquidity facilities to banks would be calibrated at 50%. These parameters are generally equivalent to those proposed under the BCBS version.

  – The proposed rule contains some additional clarifications with respect to deposit runoff assumptions. Brokered deposits, which are not explicitly addressed in the BCBS version, are assigned outflow rates based on the following factors: type of account, whether deposit insurance is in place, and the maturity date of the deposit agreement. With respect to the requirements for operational wholesale deposits, the US version excludes deposit products to provide an incentive for businesses to hold balances in excess of minimum operational requirements.

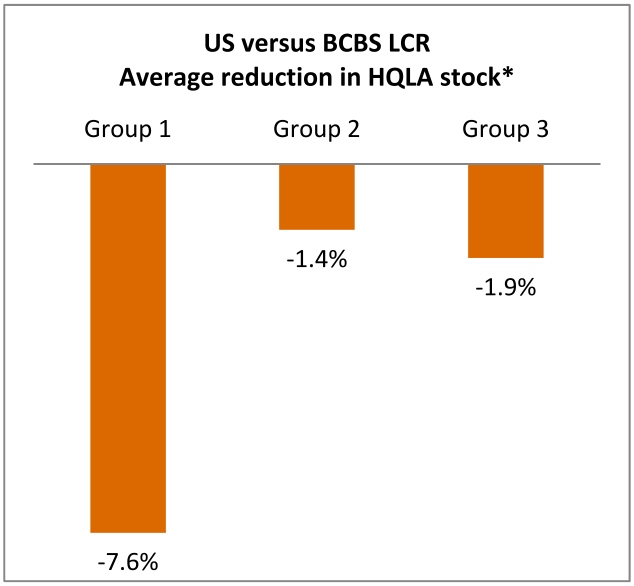
  – The differences between outflow rates applicable to larger US firms versus their smaller regional counterparts are worth noting as both could participate in similar facilities or have similar counterparties to financial transactions, yet the larger firms are expected to hold a premium amount of HQLA to cover exposures and meet the LCR threshold. The differential will have implications for industry competitive dynamics, putting large regional banks at a competitive advantage in pricing deposits.

US LCR's impact on HQLA – Large banks beware

Our assessment of the Fed's proposed treatment of HQLA (including the impact of permissible assets, haircuts, and limitations) relative to the BCBS's suggests that the largest US BHCs are by far the most impacted of the US institutions. Our preliminary analysis estimates that the largest BHCs' HQLA stock is approximately 8% lower than anticipated under the BCBS's LCR. As a result, these institutions face significant increases in trapped capital that cannot be used for lending and other business purposes.

We assessed the impact on HQLA for three types of institutions: Group 1 comprised the six largest US banking organizations by total assets; Group 2 comprised the remaining US institutions with assets greater than $250 billion; and Group 3 comprised the institutions with assets in the range of $50-250 billion (which are subject to the modified LCR).

As shown in the following table, Group 1 institutions are most adversely affected by the Fed's HQLA classification changes. These institutions have the greatest holdings of non-GSE residential mortgage-backed securities, corporate debt, and municipal securities. The other financial institutions in Group 2 and Group 3 will see a more modest impact to their stocks of HQLA.



* *applying data as of 6/30/2013*

Navigating the LCR and EPS framework in the US

The US's LCR and eventually the NSFR will complement the soon-to-be-finalized EPS rules. The LCR will be aligned with supervisory expectations for strong liquidity risk management practices and liquidity risk profiles for supervised firms.

US EPS liquidity risk management rules, as proposed, require more of banks than the LCR does. In particular, under the EPS the liquidity buffer must cover net cash outflows for 30 days *over a range of liquidity stress scenarios,* unlike the LCR which only entails a single scenario (i.e., based on prescribed inflow/outflow parameters). This range must at a minimum include three separate scenarios: market stress, idiosyncratic stress, and a combined market and idiosyncratic stress scenario.

Furthermore, the LCR is a minimum supervisory liquidity requirement whereas the EPS liquidity buffer determined by banks will need to be assessed relative to associated stress tests and account for the company's capital structure, risk profile, complexity, activities, size, and other risk factors.

For FBOs covered by the proposed EPS, the implications are less certain and could represent additional issues. Assuming the US LCR is applied in its current form to FBOs, the LCR would present challenges because eligible assets and parameters under the US version likely differ from those defined by FBO's home country supervisors, thus creating multiple calculation/estimation regimes.

What should firms be doing now?

Beyond assessing financial challenges posed by a firm's LCR-related needs, management should also re-evaluate the firm's internal processes and operational capabilities to ensure needed enhancements are appropriately identified. In particular, management should consider the following:

- *Capacity to enhance reporting processes for the LCR and liquidity risk exposures to supervisors by January 1, 2015:* The level of detail, in particular the potential need to report on individual legal entities and overseas branches, should not be underestimated (although some components are already reported to supervisors). Furthermore, the operational requirements associated with daily monitoring of the LCR, as well as the requirement to specify prospective daily cash flows, are likely to prove significantly more challenging than originally expected under BCBS. The incremental impact to regional firms will also be notable as regulators seek to upgrade oversight of these firms under the LCR.
- *Capability of the firm's existing liquidity stress testing regime to conform with EPS-related requirements and the likely emergence of a supervisory run framework for liquidity stress tests (i.e., Comprehensive Liquidity Assessment and Review) that leverages the LCR's HQLA and inflow/outflow category definitions*: EPS-covered institutions will have to make this assessment and design multiple scenarios in order to conform with expected EPS. They will have to meet requirements for demonstrating how liquidity buffers cover capital structure, risk profile, complexity, activities, size, and other risk factors. This need will require extensive documentation and internal assessments of measurement models and reporting frameworks.
- *Regulatory constraints imposed by the LCR regime will have bearing on the relative value of the various business activities that consume and generate liquidity:* Such changes will cause existing funds transfer pricing frameworks to be retooled and implemented to provide a better view of business line and product profitability after taking into consideration the additional cost of higher liquidity buffers.
- *Impact of the foregoing adjustments on certain businesses and customers/end-users:* These customers include states, municipalities, and third-party investment funds that require secured deposits or compensating balances to defray certain costs of banking products and services. In addition to assessing and refining the dimensions of such products and services, communication strategies will need to be developed for potentially impacted customers.

Appendix – Changes to HQLA haircut and cash flows assumptions between the US LCR and BCBS proposals

	BCBS Proposal	US Proposal Full LCR	US Proposal Modified LCR
General Requirements			
Applicable Firms	Internationally active banks	Large BHCs (and designated NFCs) and their subsidiary banks over $10 billion	BHCs over $50 billion
Stress Scenario	30-day stress scenario	30-day stress scenario	21-day stress scenario
Transition Period	60% on January 1, 2015, 70% on January 1, 2016, 80% on January 1, 2017, 90% on January 1, 2018, 100% on January 1, 2019 and thereafter	80% on January 1, 2015, 90% on January 1, 2016, 100% on January 1, 2017 and thereafter	80% on January 1, 2015, 90% on January 1, 2016, 100% on January 1, 2017 and thereafter
HQLA			
Qualifying RMBS rated AA or higher	Level 2B	Non-HQLA	Non-HQLA
Covered Bonds rated AA- or higher	Level 2A	Non-HQLA	Non-HQLA
Municipal Securities	Level 2A	Non-HQLA	Non-HQLA
GSE Securities (i.e., FHLMC, FNMA, FCS, and FHLB)	N/A	Level 2A	Level 2A
Net Cash Outflow			
Net Cash Outflow Calculation	Required to hold HQLA against the net cumulative cash outflow as of the end of the 30-day liquidity stress period	Required to hold HQLA against their largest net cumulative cash outflow day within a 30-day liquidity stress period	Required to hold HQLA against their net cumulative cash outflows as of the end of the 21-day liquidity stress period
Unsecured Retail Funding Runoff Rates			
Other retail funding	N/A	100%	70%
Retail Brokered Deposits Runoff Rates			
Brokered deposits that mature later than 30 calendar days from the calculation date	N/A	10%	70%
Reciprocal brokered deposits, entirely covered by deposit insurance	N/A	10%	7%
Reciprocal brokered deposits, not entirely covered by deposit insurance	N/A	25%	17.5%
Brokered sweep deposits, issued by a consolidated subsidiary, entirely covered by deposit insurance	N/A	10%	7%

	BCBS Proposal	US Proposal Full LCR	US Proposal Modified LCR
Brokered sweep deposits, not issued by a consolidated subsidiary, entirely covered by deposit insurance	N/A	25%	17.5%
Brokered sweep deposits, not entirely covered by deposit insurance	N/A	40%	28%
All other retail brokered deposits	N/A	100%	70%
Commitment Drawdown Rates			
Undrawn credit and liquidity facilities to certain banking organizations	40%	50%	35%

Additional information

For additional information about PwC's Financial Services Regulatory Practice and how we can help you, please contact:

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