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Dodd-Frank: The Liquidity Proposal is Issued

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The three Federal bank regulatory agencies have reached agreement on the terms of a proposed regulation that, for the first time, would impose quantitative requirements on major US banks' liquidity management practices. The proposal generally follows the international standard issued by the Basel Committee on Banking Supervision in early 2013 but with some twists, including an accelerated phase-in schedule. The comment period extends to the end of January 2014.

The proposal ("Liquidity Proposal") was approved yesterday by the Board of Governors of the Federal Reserve System ("Federal Reserve") in an open meeting, with adoption by the Office of the Comptroller of the Currency ("OCC") and Federal Deposit Insurance Corporation ("FDIC") expected shortly.[1] It constitutes yet another effort by US supervisors to impose prudential requirements on systemically important financial institutions in order to prevent another financial crisis and subsequent use of taxpayer funds to bail the institutions out. Poor liquidity management is considered by the supervisors to be a major cause of the financial troubles that began in 2008.

In the simplest general terms, the Liquidity Proposal would require that a major US bank do two things: calculate on each business day the amounts of its projected liquidity inflows and outflows for the following 30 days and determine the extent to which projected outflows exceed projected inflows, and then maintain high-quality liquid assets ("HQLA") in an amount sufficient to cover the projected net outflow, subject to a minimum amount of 25 percent of total outflows. Naturally, the details for making these calculations are mind-numbing, but in summary:

[1] The text is available on the Federal Reserve's website at http://www.federalreserve.gov/aboutthefed/boardmeetings/20131024openmaterials.htm. When adopted, this will be Federal Reserve Regulation WW.

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- The requirement applies to all US banks that have at least $250 billion in total assets or at least $10 billion in non-US exposure, and to bank holding companies that hold between $50 and $250 billion in total assets in modified form. It also applies to US bank holding companies meeting that size standard, and to smaller internationally-active US bank holding companies (total assets over $50 billion but less than $250 billion) but only with respect to a 21-day period rather than the full 30-day period noted above.
- Projected inflows are to be calculated on the basis of either the maturity of the bank's assets or the qualitative nature of the assets, or both, for each of the 30 days following the calculation date. For example, the total inflow expected from retail customer obligations pursuant to contractual requirement during the next 30-day period is multiplied by 50 percent, and inflow from unsecured obligations due from financial institutions is multiplied by 100 percent while inflow from other wholesale customers or counterparties is multiplied by 50 percent.
- Projected outflows are to be calculated in generally the same manner but based on the bank's obligations for each of the following 30 days. For example, the total outflow expected from "stable retail deposits" (effectively deposits that are fully covered by FDIC insurance) is 3 percent of all such deposits and from other retail deposits is 10 percent, and from committed credit facilities to non-financial corporates is 10 percent of the total undrawn amount and from committed liquidity facilities is 30 percent.
- The largest difference between projected outflows and projected inflows for any of the 30 days is the "net cash outflow amount". This is the amount that has to be covered by HQLA. However, even if the difference is less than 25 percent of total outflows, the bank has to maintain no less than 25 percent of total outflows in HQLA, for the reason that a bank should be required to have at least a significant amount of HQLA even if its calculations show that outflows are always covered by inflows. Failure to hold the minimum required HQLA for three consecutive business days would result in a requirement to provide a plan to get into compliance, and possibly stronger supervisory action.

The next issue is the types of assets that qualify as HQLA. The idea is to require that HQLA be assets that should be easily saleable promptly at, or close to, fair value. In general, there are three categories of assets that meet this standard, subject to various limitations:

- Debt securities issued or fully guaranteed by the Federal Government, Federal Reserve Bank balances above required reserves, and certain sovereign and multilateral development bank debt securities are permissible without limit. These are called Level 1 liquid assets.

- Debt securities issued or fully guaranteed by a Federal Government-sponsored enterprise that the bank believes qualify as investment grade or by certain sovereigns and multilateral banks not included in Level 1 are Level 2A liquid assets. They are subject to a 15 percent haircut (that is, only 85 percent of the asset's fair market value counts) and may total no more than 40 percent of total HQLA, including any assets that qualify as Level 2B assets described below.
- Certain publicly-issued debt securities issued by non-financial corporates that are categorized as investment grade and certain corporate common equity included in the Standard & Poor's 500 index or similar foreign index are Level 2B liquid assets. These securities are eligible because of concerns about possible shortages in the future of Level 1 and 2A securities. They are subject to a 50 percent haircut and may total no more than 15 percent of total HQLA.

Excluded from these categories are securities issued by any financial institution, defined broadly to include regulated banking and securities companies, registered and private investment funds, pension funds, and consolidated subsidiaries of any of them. In addition, municipal (State and city) debt, covered bonds and apparently mortgage-backed securities are excluded, though only municipal securities and covered bonds are mentioned explicitly; a Federal Reserve staff member said at the open meeting that mortgage-backed securities were excluded.

The bank must have the operational capability to monetize any of these assets "at any time" and either segregate them from other assets or demonstrate an ability to monetize them without conflicting with the bank's business risk or management strategy. Policies and procedures must govern the determination of HQLA on a daily basis, identify where they are held, and impose other prudential requirements. Holdings outside the United States would not be excluded from treatment as HQLA but the bank would have to be able to show that the assets can be moved to the US parent without regulatory, tax and other restrictions.

Several features of the Liquidity Proposal are notable:

- The effective date would be January 1, 2015, with a two-year phase-in period rather than the longer period in the Basel proposal. Banks would have to have 80 percent of the required HQLA during 2015, 90 percent during 2016, and 100 percent thereafter. At the open meeting, a Federal Reserve staff member, in response to a question, indicated that total HQLA would likely be $2 trillion, most large banks already have 100 percent now, and that the total shortfall in HQLA is about $200 billion. The thought may be that banks would make up that shortage by 2017.
- The calculation of required HQLA is based on the highest number on any day during the 30-day period, while the Basel proposal would have applied only to the number on the final 30th day.
- The Federal Reserve's outstanding proposals to impose enhanced supervisory requirements, including liquidity standards, on major US bank holding companies and on major foreign banking organizations ("FBOs"), would impose a variety of governance and other qualitative requirements for liquidity management, but indicated that quantitative requirements would come later. [2] Thus, the Liquidity Proposal should be read as a supplement to the earlier proposals.

[2] The US proposal was issued in December 2011 and is at 77 Fed. Reg. 594 (Jan. 5, 2012), and the FBO proposal was issued in December 2012 and is at 77 Fed. Reg. 76628 (Dec. 28, 2012). If you wish to obtain more information on these proposals, you may review our client memoranda,

- Two issues remain unexplained concerning FBOs:
  - The FBO proposal would require FBOs with total US assets outside their US branches and agencies of $10 billion or more to establish an intermediate holding company ("IHC") that would hold all of the FBO's interests in its US subsidiaries. The proposal would impose liquidity standards on IHCs and indicated that quantitative requirements would await further action. The Liquidity Proposal imposes its requirements on US organizations that are "internationally active," but it is not clear that this standard applies to all FBO IHCs. The FBO proposal suggests that it would apply to all of them; stated differently, despite the Liquidity Proposal's applicability to US organizations that are internationally active, it appears to be assumed that any IHC of a large FBO meets the standard.
  - The FBO proposal would impose liquidity requirements on US branches and agencies of an FBO with an IHC, requiring that the liquidity requirements be calculated separately for the IHC and for US branches and agencies. There was no distinction between Federally-licensed and State-licensed ones. However, the Liquidity Proposal includes a footnote stating that the OCC will not impose the quantitative requirements on Federally-licensed offices.[3] There is no mention of State-licensed offices, for which the Federal Reserve is primary Federal supervisor; accordingly, the FBO proposal's imposition of these requirements on State-licensed branches and agencies appears effective. This may have to await clarification in the final FBO adoption.
- Similarly, the FBO proposal of a year ago imposed restrictions on the holding of HQLA outside the United States. However, the Liquidity Proposal imposes fewer restrictions on the use of non-US assets as HQLA and even allows non-US issuers' common equity denominated in other currencies to qualify in order to cover net cash outflows in that jurisdiction. Final action will need to clarify the extent to which the Liquidity Proposal's rules on non-US holdings applies to FBO IHCs.

As noted above, the comment period is scheduled to end January 31, 2014. We will monitor this issue as it develops.

"Tightening the Limits on Big US Banks" (Jan. 4, 2012), at http://www.shearman.com/files/Publication/501f116e-b686-41a0-a85b-5985316b6fbe/Presentation/PublicationAttachment/130a855c-f3f1-4e73-92a9-02efef118e21/Tightening-the-Limits-on-Big-US-Banks-FIA-010412.pdf and "Dodd-Frank: The Fed's Proposal for Enhanced Supervision of Foreign Banks" (Dec. 18, 2012), at http://www.shearman.com/files/Publication/50177e86-b1d7-41ee-b5c4-f084cac36422/Presentation/PublicationAttachment/668b01f2-d3d0-4869-9fea-56424aa77c20/Dodd-Frank-Feds-Proposal-for-Enhanced-Supervision-of-Foreign-Banks-FIA-121812.pdf .

[3] Footnote 15 at page 11.

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