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The U.S. Liquidity Coverage Ratio Final Rule
Highlights and impact

On September 3, 2014, the U.S. regulatory agencies ("agencies") issued a notice of final rulemaking[1] (final rule) for the minimum liquidity standard that was proposed[2] on October 24, 2013. The final rule for the first time establishes a quantitative U.S. regulatory standard for defining liquidity and also establishes a minimum level of liquidity – a liquidity coverage ratio (LCR) – the largest banks will be required to maintain. This quantitative standard complements the enhanced prudential standards[3] finalized earlier in the year.

The final rule is substantially similar to the proposed rule. Where there are changes, the final rule generally offers modest relief in the nature of the requirements and in the time frame required for implementation. The most significant changes from the proposed rule include the provision of a phase-in of the daily LCR calculation requirement for the largest firms, and the change from a daily to a monthly calculation for firms subject to the modified LCR. Read more for highlights and Deloitte's[4] viewpoints.

Highlights

Covered companies

Banks with more than $250 billion in assets or $10 billion in foreign exposure ("covered companies") will have to comply starting January 2015, but will initially be required only to calculate the LCR monthly.

The very largest banks – those with over $700 billion in assets or $10 trillion in assets under custody – will have to perform the daily LCR calculation starting July 1, 2015. A covered company that is below both of these thresholds is only required to perform the daily calculation of LCR after July 1, 2016.

Deloitte viewpoint: While banks will still need to maintain levels of liquidity pursuant to the final rule's LCR requirement, the delayed requirement to perform a daily calculation gives banks more time to meet a significant operational challenge.

Modified LCR companies

Under the final version of the rule, U.S. banks with between $50 billion and $250 billion in assets, and which are not covered companies ("modified LCR companies") will be able to calculate their liquidity positions on a monthly basis, rather than every day as proposed in the rule's first draft last fall. Those banks also won't have to start complying with the rule until January 1, 2016, giving them an extra year to comply.

Under the final rule, stressed cash outflows are also reduced by 30 percent for modified LCR companies. This treatment is similar in concept to the proposed rule's "LCR light" calculation.

Deloitte viewpoint: This change from the proposed rule's requirement of a daily frequency of calculation provides even greater relief to banks of this size – as they are now only required to calculate the LCR monthly.

Foreign banking organizations (FBOs) and nonbank systemically important financial institutions (SIFIs)

Unless a unit of an FBO qualifies as a covered company on its own, the final rule does not apply to FBOs and intermediate holding companies required to be formed under the Federal Reserve Board's Regulation YY. The final rule also does not apply to nonbank SIFIs.

Deloitte viewpoint: The consequence of this narrower scope of application would be limited only, as the Federal Reserve Board anticipates implementing an LCR-based standard through a future separate rulemaking for these institutions.

Changes to the definition of high-quality liquid assets (HQLA)

The category of eligible debt and equity securities was broadened modestly:

- Firstly, the proposed rule required that corporate debt securities eligible for inclusion in Level 2B liquid assets be publicly traded. The final rule removed this requirement, but generally retained the other eligibility requirements for this asset class.

- Secondly, the proposed rule had limited Level 2B liquid assets only to U.S. common equity shares that were included in the Standard & Poor's 500 index. The definition has been broadened in the final rule to permit inclusion of U.S. common equity shares included in the Russell 1000 index.

Deloitte viewpoint: The final rule did not provide relief, sought by some market participants, that would allow the most liquid municipal securities to be included in HQLA. However, the staff recommended evaluating the merits of developing a new proposal that may allow such securities to be included in HQLA.

Stressed net cash outflows – changes

There were several changes to the calculation of net stressed cash outflows that we choose to highlight.

The first concerns a revision to the methodology for measuring maturity mismatches within the 30-day stress period. The methodology in the proposed rule assumed that non-maturing cash flows occurred on the first day of the 30-day calculation period. Commenters noted that this was not a reasonable assumption, resulting in an exaggerated peak cumulative outflow calculation. The final rule eliminates this assumption and addresses maturity mismatches through a change to the formula for calculating the denominator of the ratio. Thus, the U.S. LCR calculation adds an adjustment to the month-end net outflow value to account for the maximum cumulative outflow, but considers only flows with contractual maturity dates.

While this revision in methodology would generally reduce the overall requirement, a counterintuitive aspect of this methodology is that any increase in inflows after the peak day does not reduce the denominator of the ratio. In fact, due to the effect of the inflow cap, which allows only 75 percent of outflows to be offset by inflows, greater inflows subsequent to the peak day can, in some cases, actually increase the denominator.

Deloitte viewpoint: This approach offers modest relief to covered companies and reflects assumptions that are more realistic to actual conditions. The final rule describes this adjustment as increasing the operational complexity of the calculation, but we do not think this added operational burden is significant.

The second change to the calculation includes additional provisions that clarify the treatment of customer segregated funds. The added language reflects the agencies' belief that funds held in a broker-dealer's Rule 15c3-3 segregated account should be considered encumbered assets. SEC Rule 15c3-3 requires a covered company to set aside assets in a segregated account to ensure that broker-dealers have sufficient assets to meet the needs of their customers. Accordingly, the assets in Rule 15c3-3 segregated accounts are not freely available to the covered company to meet its liquidity needs and are not considered unencumbered for purposes of the final rule. However, while these accounts are excluded from eligible HQLA, the agencies are including an inflow amount with respect to certain amounts related to broker-dealer segregated accounts as detailed in section 33(g) (Broker-Dealer Segregated Account Inflow Amount) of the final rule.

Deloitte viewpoint: Utilizing the broker-dealer segregated account inflow amount requires applying the LCR inflow and outflow calculations to customer cash and collateral positions. We believe that this analysis may be difficult for many firms to perform. Accordingly, we do not believe that all firms will choose to operationalize the analysis necessary to utilize this inflow amount.

Two additional changes we wish to highlight include 1) addressing industry concerns regarding the treatment of secured public sector deposits by treating them equally to, or in certain instances more favorably than, unsecured public sector deposits; and 2) limiting the 100 percent outflow rate only to special purpose entities issuing securities or commercial paper.

Impact of the final rule

The importance of establishing a standard determination of liquidity – including a definition of high quality liquid assets – is difficult to overstate. The prior lack of a standard presented challenges in evaluating the liquidity of individual banks, and thus also impeded meaningful comparisons of liquidity between banks.

The incremental impact of the final rule will certainly vary for each institution based upon its scale and risk profile. Many institutions have been preparing for heightened liquidity standards for some time as the agencies have been demanding improvements to liquidity risk management and seeking larger liquidity buffers through the regulatory examination process and through guidance issued in 2010.[5] These earlier supervisory efforts are likely to ease the transition by banks to the new LCR requirements and enhanced prudential standards.

The FRB staff estimates that if all requirements were phased in, banks would need to hold $2.5 trillion in assets, which only implies a shortfall of $100 billion. That being said, firms will still need to spend significant effort and money to fully meet the IT and operational requirements to normalize them into their day-to-day, business as usual operations.

Lastly, and in addition, banks will need to be mindful of the pending development of net stable funding ratio and short-term wholesale funding requirements, and additional other potential liquidity risk management and reporting requirements as well. In his testimony before the Senate Banking Committee on September 9, 2014, Federal Reserve Governor Daniel Turillo stated that "the Federal Reserve contemplates near- to medium-term measures to…address the risks posed to financial stability from reliance by financial firms on short-term wholesale funding." He further stated that the "Federal Reserve staff is currently working on three sets of initiatives to address residual short-term wholesale funding risks...the first is a proposal to incorporate the use of short-term wholesale funding into the risk-based capital surcharge applicable to U.S. GSIBs. The second involves proposed modifications to the BCBS's net stable funding ratio (NSFR) standard to strengthen liquidity requirements that apply when a bank acts as a provider of short-term funding to other market participants. The third is numerical floors for collateral haircuts in securities financing transactions (SFTs)—including repos and reverse repos, securities lending and borrowing, and securities margin lending."

No doubt these pending and potential regulations may impose significant additional constraints and costs on banks as well.

Endnotes

[1] See http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20140903a1.pdf

[2] See "Liquidity Coverage Ratio: Liquidity Risk Measurement, Standards, and Monitoring" (October 24, 2013), available at http://www.federalreserve.gov/aboutthefed/boardmeetings/FR-notice-lcr-20131024.pdf

[3] See "Enhanced Prudential Standards for Bank Holding Companies and Foreign Banking Organizations," 79 FR 17240 (March 27, 2014) (Board's Regulation YY); OCC, Board, FDIC, Office of Thrift Supervision, and National Credit Union Administration.

[4] As used in this document, "Deloitte" means Deloitte & Touche LLP, a subsidiary of Deloitte LLP. Please see www.deloitte.com/us/about for a detailed description of the legal structure of Deloitte LLP and its subsidiaries. Certain services may not be available to attest clients under the rules and regulations of public accounting.

[5] "Interagency Policy Statement on Funding and Liquidity Risk Management," 75 FR 13656 (March 22, 2010).

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