SIMPSON THACHER

MEMORANDUM

New Quantitative Liquidity Requirements Proposed

October 29, 2013

On October 24, 2013, the Board of Governors of the Federal Reserve System (the "Federal Reserve") issued a notice of proposed rulemaking that would establish, for the first time, a quantitative minimum liquidity coverage ratio ("LCR") for large, internationally active banking organizations, as well as for certain systemically important nonbank financial companies designated by the Financial Stability Oversight Council (the "FSOC") for Federal Reserve supervision ("nonbank SIFIs").[1] A modified version of the LCR would apply to depository institution holding companies that are not internationally active, but have at least $50 billion in total consolidated assets (the "Modified LCR"). By requiring banking organizations to hold a stock of high quality liquid assets ("HQLA") sufficient to survive a sustained acute liquidity stress scenario, the proposal aims to avoid the liquidity squeeze and subsequent deterioration of financial markets experienced during the 2007-2008 financial crisis.

Once implemented, the rule, to be known as "Regulation WW," establishes the first standardized metric of short-term liquidity risk across banking organizations, complementing the existing supervisory approach of assessing liquidity risk management practices on a case-by-case basis and the more qualitatively focused liquidity requirements recently proposed by the Federal Reserve for very large banking organizations and nonbank SIFIs.[2] Although largely consistent with the international LCR published by the Basel Committee on Banking Supervision (the "BCBS"),[3] the proposed rule is more stringent in several respects. Most notably, the proposed rule includes an accelerated transition period, allows fewer types of

1 Both the Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency are expected to approve the proposed rule on October 30, 2013.

2 Pursuant to Section 165 of the Dodd-Frank Act, the Federal Reserve issued two proposals in late 2011 and 2012 that establish, among other things, enhanced liquidity standards for large U.S. banking organizations, certain large non-U.S. banking organizations that are subject to the Bank Holding Company Act, and nonbank SIFIs. Largely qualitative in nature, these enhanced liquidity standards address such things as corporate governance provisions, senior management responsibilities, a requirement to hold highly liquid assets to cover stressed liquidity needs based on internally developed stress models, the development of a contingency funding plan and specific limits on potential sources of liquidity risk. For background on these two proposals, which remain pending, please see our memoranda, titled "Regulating Systemically Important Financial Companies," dated January 10, 2012, *available at* http://www.stblaw.com/siteContent.cfm?contentID=4&itemID=75&focusID=1356, and "New Regulatory Framework for Foreign Banks with U.S. Operations," dated December 19, 2013, *available at* http://www.stblaw.com/siteContent.cfm?contentID=4&itemID=75&focusID=1555.

3 BCBS, "Basel III: The Liquidity Coverage Ratio and liquidity risk monitoring tools" (January 2013), *available at* http://www.bis.org/publ/bcbs238.htm.

assets to qualify as HQLA, and incorporates more conservative assumptions regarding a firm's net cash outflow during the stress period. While noting the importance of the proposed LCR in advancing the Federal Reserve's liquidity risk oversight program, Governor Daniel K. Tarullo signaled that additional regulatory reform may be forthcoming to further address potential liquidity problems at large banking firms. Comments on the proposal are due by January 31, 2014.

A. SCOPE OF APPLICATION

The proposed rule would generally impose the minimum LCR requirement on any U.S. banking organization (*e.g.*, bank holding companies, savings and loan holding companies, and depository institutions) that (*i*) has $250 billion or more in total consolidated assets, (*ii*) has $10 billion or more in total consolidated on-balance sheet foreign exposure, or (*iii*) is a depository institution subsidiary of an organization described in (*i*) or (*ii*) and has $10 billion or more in total consolidated assets. Top-tier U.S. bank holding companies and savings and loan holding companies with less than $10 billion in on-balance sheet foreign exposure and total consolidated assets between $50 billion and $250 billion would be subject to the Modified LCR. A banking organization which does not meet the asset thresholds for automatic application of the LCR or Modified LCR may nevertheless be subject to the LCR requirement if the applicable federal banking agency determines that application would be appropriate in light of the company's asset size, complexity, and risk profile (subject to notice and response procedures established under the prompt corrective action provisions of the Federal Deposit Insurance Act).

The minimum LCR requirement would also apply to certain nonbank SIFIs,[4] regardless of asset size.

Notably, top-tier bank holding companies and savings and loan holding companies and nonbank SIFIs with substantial insurance activities (*i.e.*, companies that perform insurance underwriting activities or hold at least 25% of their total assets in subsidiaries that perform insurance underwriting activities) and top-tier savings and loan holding companies with substantial commercial operations (*i.e.*, grandfathered unitary thrift holding companies with 50% or more of their total consolidated assets or revenues on an enterprise-wide basis derived from activities that are not covered by Section 4(k) of the Bank Holding Company Act) are not subject to the proposal. This exemption reflects the Federal Reserve's view that the liquidity requirements in the proposed rule were not designed to address the liquidity risk profile of insurance companies.

B. THE MINIMUM LCR REQUIREMENT

Upon taking full effect, the proposed rule would require a covered institution to achieve and maintain an LCR of at least 100%. The LCR would be calculated as the ratio of two components: (*i*) the value of the firm's stock of high quality liquid assets under stressed conditions; and (*ii*) total projected net cash outflows during a 30-day stress scenario (or, in the case of the Modified LCR, during a 21-day stress scenario).

---

4 To date, the FSOC has made three nonbank SIFI designations: American International Group, General Electric Capital Corporation, and Prudential Financial.

1. The LCR Numerator: High Quality Liquid Assets

To achieve the LCR's goal of ensuring sufficient liquidity during an acute stress scenario, assets to be counted towards the minimum LCR as HQLA must be readily convertible into cash, through sale or secured borrowing, with little or no loss of value during a period of liquidity strain. Accordingly, the proposed rule requires all HQLA to satisfy the following criteria:

- *"Liquid and Readily Marketable"*—Securities included in HQLA must be traded in an active secondary market with more than two committed market makers, a large number of non-market maker participants on both the buying and selling sides of transactions, timely and observable market prices, and a high trading volume.
- *"Unencumbered"*—All assets included in HQLA must be free of legal, regulatory, contractual, or other restrictions on the ability of the firm to monetize the asset, and the assets must not be pledged to secure or provide credit enhancement to any transaction. Assets may nevertheless be included in HQLA if they are pledged to a central bank or U.S. government-sponsored enterprise ("GSE").
- *"Not an Obligation of a Regulated Financial Company"*—Assets included in HQLA must not be issued by financial sector entities, since such assets would carry wrong-way risk correlation with covered institutions.
- *Separate Assets of the Bank*—Assets included in HQLA must not be designated to cover operational costs of the covered banking organization, and must not be securities owned by a customer of the covered banking organization, regardless of the banking organization's hypothecation rights to the customer's securities.

The proposed rule further divides qualifying HQLA into three sub-categories, based on the nature of the asset and its issuer. Because the three HQLA categories involve varying risk profiles, each would be subject to corresponding caps and asset-value "haircuts," as described below. The LCR numerator would then be calculated by summing the risk-adjusted asset values from each of the following HQLA categories:

- *Level 1 Liquid Assets*: Assets with the highest potential to generate liquidity for a covered institution during periods of acute liquidity stress. Level 1 assets would be included in the HQLA amount without limit, and without being subject to a value-based haircut. Under the proposed rule, Level 1 assets include (*i*) excess reserves held at the Federal Reserve; (*ii*) withdrawable reserves held at a foreign central bank; (*iii*) securities issued by, or guaranteed by the full faith and credit of, the U.S. government; and (*iv*) certain securities issued by or guaranteed by a foreign sovereign, central bank, or other international entity that are assigned a 0% risk weight under the standardized approach of the revised regulatory capital rules.[5]

---

[5] This generally would include all OECD sovereign debt unless the debt was in default or restructured consistent with the Federal Reserve's recently revised capital regulations under Basel III. *See* 78 Fed. Reg. 62018 (Oct. 11, 2013).

- *Level 2A Liquid Assets*: Level 2A assets would be included in the HQLA amount subject to a 15% haircut off the assets' current market value. The combined values of Level 2A and Level 2B assets could not comprise more than 40% of a covered institution's total HQLA stock, after applicable haircuts have been applied. Under the proposed rule, Level 2A assets would include (*i*) claims on or guaranteed by a GSE that are investment-grade and senior to preferred stock in the GSE, and (*ii*) claims on or guaranteed by a foreign sovereign or multilateral development bank that are assigned a 20% risk weight under the standardized approach of the revised regulatory capital rules.
- *Level 2B Liquid Assets*: Level 2B assets would be included in the HQLA amount subject to a 50% haircut off the assets' current market value. The combined values of Level 2A and Level 2B assets could not comprise more than 40% of a covered institution's total HQLA stock, after applicable haircuts have been applied. Level 2B assets could comprise no more than 15% of a covered institution's total HQLA stock, after applicable haircuts have been applied. Under the proposed rule, Level 2B assets would include (*i*) investment-grade, publicly traded corporate debt securities, and (*ii*) publicly traded equity securities that are included in the Standard & Poor's 500 Index (or an equivalent acceptable index).

COMPARISON OF CERTAIN ASSET CATEGORIES		
	U.S. Proposal HQLA Category	**BCBS HQLA Category**
Claims On or Guaranteed by U.S. GSEs	Level 2A	Level 1
Investment-Grade Corporate Debt Securities	Level 2B	Level 2A
Non-Investment-Grade Corporate Debt Securities	Not HQLA	Level 2B
Private Label Residential Mortgage-Backed Securities[6]	Not HQLA	Level 2B (subject only to a 25% haircut)

As illustrated in the table above, the proposed rule is considerably more stringent than the BCBS approach in that some categories of assets, such as non-investment-grade corporate debt

6 During the Federal Reserve's open meeting on October 24, 2013, a member of the Federal Reserve staff stated that, in contrast to the BCBS approach, some assets such as "private label mortgage-backed securities" are indeed excluded from the proposal as liquid assets "due to the relative lack of liquidity and other factors." Transcript of Open Meeting of the Federal Reserve (Oct. 24, 2013), *available at* http://www.federalreserve.gov/mediacenter/files/open-board-meeting-transcript-20131024.pdf. The proposal does not explicitly address the treatment of residential mortgage-backed securities that are issued or guaranteed by a GSE, but because the proposal includes securities issued by a GSE in Level 2A HQLA if such securities are investment-grade and "senior to preferred stock" in the GSE, residential mortgage-backed securities issued or guaranteed by a GSE should be included in Level 2A HQLA.

securities and private label residential mortgage-backed securities, will have no value for purposes of U.S. liquidity requirements.

2. The LCR Denominator: Total Net Cash Outflow

The amount of HQLA held by covered institutions would need to be sufficient to offset the firm's total net cash outflow amount during the relevant liquidity stress period. To calculate its total net cash outflow for purposes of the LCR requirement, a covered firm would first calculate its daily net cash outflow each day during the stress period, by subtracting that day's expected cash inflow from that day's expected cash outflow. The firm would then calculate its cumulative net cash outflow for each day during the stress period, by summing the daily net cash outflows for each preceding day during the stress period.[7] The firm's total net cash outflow (the LCR denominator) would then be equal to the peak cumulative net cash outflow (*i.e.*, the cumulative net cash outflow that is higher than any other day's cumulative net cash outflow during the stress period).

This calculation differs significantly from that involved in the BCBS LCR. Rather than selecting the peak cumulative net cash outflow, the BCBS LCR sets as its denominator the total cumulative net cash outflow, summed over the course of the entire stress period. The federal banking agencies view the proposal's methodology as an improvement over the BCBS methodology, since it takes into account the risk that a covered company could have a substantial amount of cash inflows late in the stress period while also having substantial outflows early in the same period.

The proposed LCR requirement contemplates a stress test period lasting 30 days after each calculation date, while the proposed Modified LCR requirement contemplates a stress period lasting 21 days after each calculation date.

<table>
<tr><th colspan="8">SIMPLIFIED COMPARISON OF TOTAL NET CASH OUTFLOW CALCULATIONS
(5 DAY STRESS PERIOD)</th></tr>
<tr><th></th><th>Day 1</th><th>Day 2</th><th>Day 3</th><th>Day 4</th><th>Day 5</th><th>Total Net Cash Outflow (U.S. Proposal)</th><th>Total Net Cash Outflow (BCBS)</th></tr>
<tr><td>Daily Cash Outflow</td><td>100</td><td>100</td><td>100</td><td>100</td><td>100</td><td rowspan="4">225</td><td rowspan="4">150</td></tr>
<tr><td>Daily Cash Inflow</td><td>0</td><td>25</td><td>50</td><td>125</td><td>150</td></tr>
<tr><td>Daily Net Cash Outflow</td><td>100</td><td>75</td><td>50</td><td>(25)</td><td>(50)</td></tr>
<tr><td>Cumulative Net Cash Outflow</td><td>100</td><td>175</td><td>225</td><td>200</td><td>150</td></tr>
</table>

[7] In calculating cumulative net cash outflows, cumulative cash inflows would be capped at 75% of cumulative cash outflows. This cap would prevent a company from relying exclusively on projected cash inflows to cover its liquidity needs, since such inflows may not materialize in a period of liquidity strain.

(i) *Stressed Cash Outflows*

The proposed rule includes various predetermined run-off rates to be used in calculating projected cash outflow, which are intended to approximate outflows experienced during periods of severe liquidity stress. The run-off rates are consistent with those included in the BCBS LCR, and vary based on the source of the covered firm's funding. Examples of relevant run-off rates in the proposed rules include:

- *Unsecured Retail Funding Cash Outflow*—Outflow rates would range from 3% for stable retail deposits that are fully FDIC-insured to 40% for uninsured retail brokered sweep deposits. Brokered deposits that are entirely covered by FDIC deposit insurance would have an outflow rate of 10%, if issued by a consolidated subsidiary, and 25%, if not issued by a consolidated subsidiary.
- *Unsecured Wholesale Funding Cash Outflow*—Outflow rates would range from 25% for operational deposits to 100% for commercial paper or non-operational deposits from financial entities.
- *Secured Short-Term Funding Cash Outflow*—Outflow rates would correspond to the liquidity characteristics of the collateral, including 0% for funding secured by Level 1 HQLA, 15% for funding secured by Level 2A HQLA, 50% for funding secured by Level 2B HQLA, and 100% for funding secured by non-HQLA.
- *Commitments Cash Outflow*—Outflow rates would range from 5% for undrawn retail credit facilities to 40% for most undrawn corporate credit facilities, and 50% for undrawn credit facilities to banks.

(ii) *Stressed Cash Inflows*

In calculating projected cash inflow, the proposed rule would specifically exclude from cash inflows several categories of items that the federal banking agencies consider to be insufficiently reliable sources of liquidity during a stressed scenario. Items that would not be counted towards a covered firm's cash inflows include (*i*) operational deposits that the covered firm holds at other regulated financial companies; (*ii*) amounts that the covered firm expects to receive from mortgage-related derivative transactions; (*iii*) amounts arising from credit or liquidity facilities extended to the covered firm; (*iv*) any assets that the covered firm has included in its HQLA amount, and any amounts payable to the covered firm with respect to those assets; (*v*) outstanding exposures that are nonperforming as of the calculation date, or which the covered firm has reason to expect will become nonperforming within the stress period; and (*vi*) items that have no contractual maturity date.

For non-excluded inflow items, the proposed rule includes various assumed inflow rates which are meant to reflect the likelihood of the projected inflow items materializing during a stressed liquidity scenario. Examples of relevant inflow rates in the proposed rules include:

- *Unsecured Retail Cash Inflow*—A covered firm could count as inflow 50% of all contractual payments it expects to receive from retail customers within the applicable stress period.
- *Unsecured Wholesale Cash Inflow*— A covered firm could count as inflow 100% of all wholesale inflows (including principal and interest) it expects to receive from regulated financial companies, investment companies, non-regulated funds, pension funds, investment advisers, and central banks. However, a covered firm could count as inflow only 50% of inflows due from wholesale customers that are not regulated financial companies, investment companies, non-regulated funds, pension funds, investment advisers, or central banks.
- *Secured Short-Term Lending Cash Inflow*—Inflow rates would correspond to the liquidity characteristics of the collateral, including 0% for lending secured by Level 1 HQLA, 15% for lending secured by Level 2A HQLA, 50% for lending secured by Level 2B HQLA, and 100% for lending secured by non-HQLA.
- *Securities Cash Inflow*— A covered firm could count as inflow 100% of all contractual payments it expects to receive from securities owned by the covered firm that are not included in the firm's HQLA amount.

C. MECHANICS OF THE LCR REQUIREMENT

The proposed rule would require a covered institution to calculate its LCR daily, as of a consistent time of day. The time of day at which a company would calculate its LCR would be selected by the company prior to the proposed rule's effective date, and would be communicated in writing to the company's primary federal banking regulator. Upon making this election, any change in the time of day at which a covered institution calculates its LCR would require the written approval of its primary federal banking regulator.

In addition to requiring that covered firms hold a minimum stock of HQLA, the proposed rule would impose certain operational requirements to ensure that a firm's stock of HQLA could be efficiently liquidated in times of stress. To this end, covered institutions would be required to demonstrate the following capabilities:

- *Determining the Composition of HQLA*—As part of its ongoing monitoring of HQLA, a covered firm would need to exhibit a command over the location and diversification of its HQLA, while ensuring that the assets included in its HQLA stock continue to qualify as HQLA.
- *Monetizing HQLA If and When Necessary*—A covered firm would be required to implement appropriate systems allowing it to monetize its HQLA at any time, and would be required to periodically monetize a sample of its HQLA that reflects the composition of the firm's broader HQLA portfolio to confirm access to relevant markets.

- *Controlling HQLA Under the Firm's Liquidity Risk Management Function*—A covered firm's liquidity risk management function would need to have full authority to liquidate HQLA when necessary, as well as full access to funds resulting from monetized HQLA, without conflicting with another business or risk management strategy.

The proposed rule would require covered firms to notify their primary federal banking regulator on any business day that its LCR is below the required minimum LCR, but allows for a flexible supervisory response to the inadequate LCR. This flexibility is largely in recognition that a covered firm may occasionally need to access its HQLA to fund unanticipated liquidity needs. However, if a covered firm's LCR were to remain below the minimum requirement for three consecutive business days, the covered firm would be required to submit a plan for remediation to its primary federal banking regulator. The federal banking agencies would have discretionary authority to take supervisory or enforcement actions to address noncompliance with the LCR requirement.

D. GENERAL TIMING

The proposed rule contemplates full compliance with the LCR by January 1, 2017, but adopts a phase-in transition period to mitigate the burden of compliance on covered institutions and financial markets. Covered institutions would be required to achieve an LCR of at least 80% by January 1, 2015, and an LCR of at least 90% by January 1, 2016. Beginning January 1, 2017, covered institutions would be required to maintain an LCR of at least 100% on an ongoing basis.

By contrast, as illustrated in the table below, the BCBS LCR includes an extended transition period and would not require full compliance until January 1, 2019. Under the BCBS phase-in plan, the minimum LCR for covered institutions will be set at 60% beginning January 1, 2015, and will thereafter increase by 10% annually until January 1, 2019.

COMPARISON OF LCR TRANSITION PERIODS					
	January 1, 2015	**January 1, 2016**	**January 1, 2017**	**January 1, 2018**	**January 1, 2019**
Minimum LCR (U.S. Proposal)	80%	90%	100%	100%	100%
Minimum LCR (BCBS)	60%	70%	80%	90%	100%

The federal banking agencies have justified the proposed rule's accelerated timeline based on the perceived importance of the LCR in promoting a healthy banking sector, and on their desire to reinforce the improvement of liquidity positions since the financial crisis.

E. ADDITIONAL LIQUIDITY-RELATED INITIATIVES AROUND THE CORNER

In a prepared statement, Governor Tarullo noted that the proposed LCR requirement marks an "important advance in prudential regulation," but cautioned that the LCR alone is "not sufficient to address potential liquidity problems at large banking firms." In particular, Governor Tarullo noted that while the LCR creates a liquidity cushion sufficient to cover a 30-day stress scenario, liquidity strains can last considerably longer. To address such longer-term liquidity strains, the BCBS included in its 2010 liquidity framework a minimum net stable funding ratio ("NSFR"), which would ensure that covered institutions finance long-term assets with sufficient long-term, stable funding. The BCBS is currently in the process of reviewing its 2010 proposed NSFR, and the federal banking agencies are considering what changes to the NSFR they may recommend to the BCBS. Governor Tarullo stated that the BCBS is "well along in creating a final [NSFR] product," and expressed his anticipation that the Federal Reserve would propose a U.S. NSFR rule consistent with the final BCBS rule.

In focusing on the liquidity of individual firms, both the proposed LCR and the forthcoming NSFR represent microprudential advances in liquidity reform. Governor Tarullo noted, however, that the LCR does not address the macroprudential risks existing in the modern banking sector, such as large negative externalities caused by asset fire sales and the interconnectedness resulting from widespread matched-book financing. According to Governor Tarullo, regulatory measures addressing such macroprudential concerns, particularly systemic risks posed by banks' use of short-term wholesale funding, should rank among the Federal Reserve's "highest remaining priorities."

* * *

For more information, please contact a member of Simpson Thacher's Financial Institutions Group.

Lee Meyerson (212) 455-3675 lmeyerson@stblaw.com	Lesley Peng (212) 455-2202 lpeng@stblaw.com
Maripat Alpuche (212) 455-3971 malpuche@stblaw.com	Roxane Reardon (212) 455-2758 rfreardon@stblaw.com
Elizabeth Cooper (212) 455-3407 ecooper@stblaw.com	Mark Chorazak (212) 455-7613 mchorazak@stblaw.com
Andrew Keller (212) 455-3577 akeller@stblaw.com	Spencer Sloan (212) 455-7821 spencer.sloan@stblaw.com

This memorandum is for general information purposes and should not be regarded as legal advice. Please contact your relationship partner if we can be of assistance regarding these important developments. The names and office locations of all of our partners, as well as our recent memoranda, can be obtained from our website, www.simpsonthacher.com.

IRS Circular 230 disclosure: To ensure compliance with requirements imposed by the IRS, we inform you that any tax advice contained in this memorandum was not intended or written to be used, and cannot be used, for the purpose of avoiding tax-related penalties under federal, state or local tax law. Each taxpayer should seek advice based on the taxpayer's particular circumstances from an independent tax advisor.

UNITED STATES

New York
425 Lexington Avenue
New York, NY 10017
+1-212-455-2000

Houston
2 Houston Center
909 Fannin Street
Houston, TX 77010
+1-713-821-5650

Los Angeles
1999 Avenue of the Stars
Los Angeles, CA 90067
+1-310-407-7500

Palo Alto
2475 Hanover Street
Palo Alto, CA 94304
+1-650-251-5000

Washington, D.C.
1155 F Street, N.W.
Washington, D.C. 20004
+1-202-636-5500

EUROPE

London
CityPoint
One Ropemaker Street
London EC2Y 9HU
England
+44-(0)20-7275-6500

ASIA

Beijing
3919 China World Tower
1 Jian Guo Men Wai Avenue
Beijing 100004
China
+86-10-5965-2999

Hong Kong
ICBC Tower
3 Garden Road, Central
Hong Kong
+852-2514-7600

Seoul
West Tower, Mirae Asset Center 1
26 Eulji-ro 5-gil, Jung-gu
Seoul 100-210
Korea
+82-2-6030-3800

Tokyo
Ark Hills Sengokuyama Mori Tower
9-10, Roppongi 1-Chome
Minato-Ku, Tokyo 106-0032
Japan
+81-3-5562-6200

SOUTH AMERICA

São Paulo
Av. Presidente Juscelino Kubitschek, 1455
São Paulo, SP 04543-011
Brazil
+55-11-3546-1000