Basel III Liquidity Framework

Federal Reserve Approves Final Rule Implementing Basel III Liquidity Coverage Ratio for Large U.S. Banks

SUMMARY

On Wednesday, September 3, the Board of Governors of the Federal Reserve System (the “Federal Reserve”), the Office of the Comptroller of the Currency (the “OCC”) and the Federal Deposit Insurance Corporation (the “FDIC” and, together with the Federal Reserve and OCC, the “Agencies”) approved a final rule (the “Final Rule”) implementing a quantitative liquidity coverage ratio (“LCR”) requirement for certain large domestic bank holding companies, savings and loan holding companies and depository institutions (“covered companies”), as well as a modified and less stringent LCR for other banking organizations with $50 billion or more in total consolidated assets. The LCR is intended to ensure that banking organizations hold sufficient stock of “high quality liquid assets” (“HQLA”) to cover the anticipated net cash flows during an acute 30-day stress scenario.

Although it includes a number of important changes in response to public comment, the Final Rule is largely similar to the rule initially proposed in October 2013 (the “Proposed Rule”). Notable changes include:

- **Timing of compliance.** The Final Rule retains the January 1, 2015 initial compliance date for covered companies subject to the full LCR. However, the daily calculation requirement is delayed until July 1, 2015 for the largest banking organizations and July 1, 2016 for all other banking organizations subject to the full LCR. In the interim, calculation will be required on a monthly basis.
  - The initial compliance date for covered companies subject to the modified LCR is delayed until January 1, 2016. These covered companies will be subject only to a monthly reporting requirement thereafter.

- **Peak-day.** Although it continues to address potential maturity mismatches between outflows and inflows, the Final Rule eliminates the assumption that all transactions without a specified maturity date result in an outflow on the first day of each 30-calendar-day measurement period.
period. The Final Rule, however, includes a new calculation methodology that is designed to capture such potential mismatches but only from specific types of transactions, such as repos and reverse repos with financial sector entities, that the Agencies believe are most likely to expose covered companies to maturity mismatches within the 30-day period.

- **Collateralized deposits.** For the calculation of HQLA, covered companies are not required to apply the hypothetical unwind to certain collateralized deposits that are unlikely to be manipulated by a covered company for HQLA purposes.

In light of ongoing analysis, the Agencies left open the possibility that certain municipal securities may be sufficiently liquid to be included as HQLA, which would be the subject of a future proposal for public comment.

The Final Rule does not currently apply to foreign banking organizations or U.S. intermediate holding companies required to be formed under the Federal Reserve’s enhanced prudential standards mandated by Section 165 of Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") that do not otherwise qualify as covered companies. However, the Federal Reserve reaffirmed its plans to issue additional rulemaking in the future to apply an LCR-based standard to the U.S. operations (possibly including U.S. branches) of some or all foreign banking organizations with $50 billion or more in combined U.S. assets. In addition, unlike the Proposed Rule, the Final Rule does not apply to nonbank financial companies designated by the Financial Stability Oversight Council for supervision by the Federal Reserve. Instead, enhanced liquidity requirements would be applied to such firms by rule or order.

The Final Rule continues to be more restrictive than the international liquidity standards (the “Basel III LCR”) published by the Basel Committee on Banking Supervision (the “Basel Committee”) in a number of significant respects, including the accelerated implementation schedule and peak-day calculation requirement noted above. The Final Rule’s accelerated timeframe affirms the Agencies’ willingness to proceed with implementing the LCR notwithstanding the slower pace of European regulators in adopting similar rules.

This memorandum highlights certain key features of the Final Rule, focusing on the more significant changes from the Proposed Rule and areas where the industry sought changes in the Proposed Rule that the Agencies did not include. For reference, the Appendix hereto provides a brief, high-level introduction and summary of the LCR.

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**FUTURE ACTIONS**

At the Federal Reserve’s meeting approving the Final Rule, Federal Reserve Governors and staff emphasized that the LCR is only one component of a broader liquidity management framework, which includes company-run liquidity stress test and other related requirements under the enhanced prudential requirements of Section 165 of Dodd-Frank and the Federal Reserve’s supervisory Comprehensive Liquidity Analysis and Review Program. The preamble to the Final Rule cautions that “the LCR is a minimum requirement and organizations that pose more systemic risk to the U.S. banking system or
whose liquidity stress testing indicated a higher need for higher liquidity reserves may need to take additional steps beyond meeting minimum ratio to meet supervisory expectations.”

In addition, Governor Tarullo and Federal Reserve staff previewed forthcoming regulatory initiatives that also are designed to address liquidity concerns that are beyond the scope of the LCR, including:

- the net stable funding ratio, which addresses liquidity outside of the 30-day calendar period and certain concerns related to matched repo books;
- incorporation of reliance on short-term wholesale funding in determining the amount of the capital surcharge for the most systemic banking organizations; and
- potential minimum collateral haircuts or margin requirements on securities financing transactions.

Several governors also raised concerns that covered companies would be reluctant to dip into HQLA and risk falling below the minimum LCR requirement, which may have to be disclosed publicly at some point or result in supervisory consequences. Staff acknowledged that under certain circumstances it may be necessary or desirable for a covered company’s LCR to fall below 100% in order for the organization to use its HQLA to weather a liquidity stress event. As a result, staff anticipates that the framework would allow supervisors the flexibility to respond to unique circumstances triggering the liquidity stress and that communications with banking organizations would be part of the supervisory process, but noted that communications with the broader market may at times be necessary. It remains to be seen how the need for flexibility in administering the LCR will be balanced with public disclosure requirements. The preamble to the Final Rule notes that the Agencies anticipate seeking comment in a future notice on reporting requirements “which will be tailored to disclose the appropriate level of information.” They note further that other than public disclosure requirements, reports to the Agencies of any decline in an LCR below 100% and related supervisory actions would be considered confidential supervisory information.

**DISCUSSION – HIGHLIGHTS**

The Final Rule implements the Basel III LCR published by the Basel Committee in January 2013. Like the Basel III LCR, the Final Rule seeks to address the perceived weaknesses in liquidity risk management by banking organizations and other financial institutions during the financial crisis. While the U.S. implementation generally follows the international blueprint set out by the Basel III LCR, the Final Rule is more restrictive than the Basel III LCR in several significant respects. The Agencies believe that these departures from the Basel III LCR reflect unique supervisory and market conditions in the United States.

Highlights of the Final Rule include the following.

**A. APPLICABILITY**

The Final Rule applies as follows.
Full LCR. The full LCR applies to (i) bank holding companies and savings and loan holding companies with $250 billion or more in total consolidated assets or $10 billion or more in foreign exposures – the so-called “advanced approaches” banking organizations and (ii) consolidated insured depository institutions subsidiaries of advanced approaches banking organizations with $10 billion or more in total consolidated assets.

Modified LCR. The modified LCR applies to Bank holding companies and savings and loan holding companies with at least $50 billion in total consolidated assets that are not internationally active.

The Final Rule applies the LCR to insured depository institution subsidiaries of covered companies notwithstanding commenters’ concerns that this requirement would lead to excess liquidity being trapped at these subsidiaries. The Final Rule does clarify that the 100% affiliate outflow rate under Section 32(h)(2) of the Final Rule applies only to funding from entities that are a consolidated subsidiary of the same parent company of which the covered company is a consolidated subsidiary (that is, sister companies), but not to funding from a consolidated subsidiary of the covered company. Funding between a covered company and its consolidated subsidiaries is not subject to the 100 percent outflow rate.

The Final Rule does not currently apply to foreign banking organizations or to U.S. intermediate holding companies required to be formed under the Federal Reserve’s enhanced prudential standards mandated by Section 165 of Dodd-Frank that do not otherwise qualify as covered companies. However, the Federal Reserve reaffirmed its plans to issue additional rulemaking sometime in the future to apply an LCR-based standard to the U.S. operations (possibly including U.S. branches) of some or all foreign banking organizations with $50 billion or more in combined U.S. assets.

Unlike the Proposed Rule, the Final Rule does not apply to nonbank financial companies designated by the Financial Stability Oversight Council for supervision by the Federal Reserve. Instead, enhanced liquidity requirements would be applied to such firms by rule or order.

The following Tables shows the compliance date for each type of organization subject to the LCR and when the organization must begin daily reporting.

<table>
<thead>
<tr>
<th>Implementation of Final Rule</th>
<th>Full LCR</th>
<th>Modified LCR</th>
</tr>
</thead>
<tbody>
<tr>
<td>Transition Period</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Calendar Year 2015</td>
<td>80%</td>
<td>Not applicable</td>
</tr>
<tr>
<td>Calendar Year 2016</td>
<td>90%</td>
<td>90%</td>
</tr>
<tr>
<td>Calendar Year 2017</td>
<td>100%</td>
<td>100%</td>
</tr>
</tbody>
</table>
Table 2: Calculation Frequency

<table>
<thead>
<tr>
<th>Type of Covered Company</th>
<th>Monthly Calculation of LCR</th>
<th>Daily Calculation of LCR</th>
</tr>
</thead>
<tbody>
<tr>
<td>Covered depository institution holding companies with $700 billion or more in total</td>
<td>Beginning January 1, 2015</td>
<td>Beginning July 1, 2015 and</td>
</tr>
<tr>
<td>consolidated assets or $10 trillion or more in assets under custody, and any depository</td>
<td></td>
<td>thereafter</td>
</tr>
<tr>
<td>institution that is a consolidated subsidiary of such depository institution holding</td>
<td></td>
<td></td>
</tr>
<tr>
<td>companies that has total consolidated assets equal to $10 billion or more</td>
<td></td>
<td></td>
</tr>
<tr>
<td>All other covered companies subject to the full LCR</td>
<td>Beginning January 1, 2015</td>
<td>Beginning July 1, 2016 and</td>
</tr>
<tr>
<td></td>
<td></td>
<td>thereafter</td>
</tr>
<tr>
<td>Covered companies subject to the modified LCR</td>
<td>Beginning January 1, 2016 and thereafter</td>
<td>Not applicable</td>
</tr>
</tbody>
</table>

B. HQLA

The Final Rule retains the HQLA requirements from the Proposed Rule with only minor adjustments. Under the Final Rule, the numerator of the LCR consists of a covered company’s stock of HQLA. Almost all assets included in HQLA must be liquid and readily marketable, meaning that the asset must be traded in an active secondary market with more than two committed market-makers, a large number of committed non-market-maker participants on both the buying and selling sides of transactions, timely and observable market prices and high trading volumes. In order to qualify for inclusion in a covered company’s HQLA, assets must meet certain operational requirements. For example, the covered company must demonstrate that it has the operational capacity to monetize the assets, must maintain policies requiring all HQLA to be under the control of a covered company’s management team responsible for managing liquidity risk and have the ability to assess the daily composition of a covered company’s HQLA. The preamble to the Final Rule clarifies that monetization may be demonstrated through repos and is not limited to outright sales.

Like the Proposed Rule, the Final Rule divides HQLA into three categories: Level 1, Level 2A and Level 2B. Level 1 liquid assets are the highest quality and most liquid, such as central bank reserves, securities fully guaranteed by the full faith and credit of the U.S. government and certain sovereign and multilateral organization securities. An unlimited amount of Level 1 liquid assets may be counted toward a covered company’s HQLA at their full fair values. Level 2A liquid assets are considered stable enough to be included in HQLA, but at a 15% haircut and subject to the overall limitation that Level 2A and Level 2B liquid assets combined cannot exceed 40% of the total stock of HQLA. Level 2A liquid assets include investment-grade securities issued by government-sponsored enterprises and certain claims guaranteed by a sovereign entity or multilateral development bank. Level 2B liquid assets are the riskiest assets that may be included in HQLA, but are subject to a 50% haircut and cannot exceed 15% of the total stock of HQLA. Level 2B liquid assets include certain corporate debt securities and publicly traded shares of common stock.
In calculating its HQLA amount, a covered company must apply a hypothetical unwind to secured funding transactions, secured lending transactions, asset exchanges or collateralized derivative transactions that mature within 30-calendar days of the calculation date and where the covered company and the counterparty exchange HQLA. This unwind requirement is designed to prevent a covered company from engaging in transactions to bolster its stock of HQLA and create the appearance of significant liquid assets at the beginning of a 30-calendar-day stress period that would unwind by the end of the period.

The preamble to the Final Rule clarifies that for LCR calculation purposes covered companies are only required to unwind transactions involving assets that meet the operational requirements for HQLA, including the requirement that eligible HQLA is under the control of the management team responsible for managing liquidity risk.

Other than leaving open the possibility of a future proposal that would consider whether certain state and municipal securities should qualify as HQLA, the Agencies generally made no significant additions, other than relatively minor adjustments, to qualifying HQLA despite significant industry comment. For example, the Final Rule broadens the scope of publicly traded common equity securities potentially includible as Level 2B liquid assets by replacing the requirement that a common equity security be included in Standard & Poor’s 500 Index (“S&P 500”) with a requirement that it be included in the Russell 1000 Index. As a result, however, the Final Rule eliminates the provision that would have allowed a covered company to demonstrate that equity securities included in an index other than the S&P 500 should be eligible for inclusion in Level 2B liquid assets. The Final Rule also eliminates the requirement that corporate debt securities themselves be publicly traded and instead require only that the issuer have publicly traded common equity securities, among other requirements that are unchanged from the Proposed Rule.

**Unwind of Collateralized Deposits.** Unlike the Proposed Rule, the Final Rule does not require a covered company to apply the unwind requirement to certain collateralized deposits for purposes of calculating HQLA, accepting commenters’ arguments that preferred deposits and corporate trust deposits that must be collateralized under applicable law were unlikely to be subject to the manipulation the unwind requirement is meant to address. The Final Rule includes the following new definition of collateralized deposits to clarify the deposits that are not subject to the requirement:

- a deposit of a public-sector entity held at the covered company and that gives the depositor, as holder of the lien, priority over the assets in the event the covered company enters into receivership, bankruptcy, insolvency, liquidation, resolution or similar proceeding, or
- a deposit of a fiduciary account held by a covered company for which the covered company is a fiduciary and sets aside assets owned by the covered company as security and that gives the depositor priority over the assets in the event the covered company enters into receivership, bankruptcy, insolvency, liquidation, resolution or similar proceeding.

**C. TOTAL NET CASH OUTFLOWS**

The Final Rule includes changes to both the calculation of total net cash outflows as well as the types of outflows that must be included in the denominator and their associated outflow rates, as described below.
The denominator of the LCR consists of total net cash outflows, which is the minimum amount that must be offset by a covered company’s HQLA amount. Net cash outflows generally are determined by calculating cash outflows and inflow amounts over the 30-calendar-day period by applying a standardized set of outflow and inflow rates. The inflows and outflows are then aggregated and netted against each other. Cumulative inflow amounts are capped at 75% of cumulative outflow amounts (thereby effectively requiring a minimum amount of HQLA even if a covered company has perfectly matched its contractual inflows and outflows), with an exception for inflows from certain foreign currency exchange derivative transactions that require an exchange of currencies with the same business day.  

The Final Rule introduces a new approach to addressing potential maturity mismatch, as described below.  

**Peak-day.** Although the Final Rule continues to address potential maturity mismatches between a covered company’s outflows and inflows, the Final Rule eliminates the assumption that all transactions and instruments that do not have a contractual maturity date have flow out on the first day of the 30-calendar-day calculation period. The assumption, however, continues to apply to certain non-maturity transactions and instruments, such as repurchase and reverse repurchase agreements with financial sector entities. These transactions are included in an “add-on approach” in the Final Rule that addresses the potential mismatch. The Agencies acknowledge that this add-on approach involves operational challenges and may result in covered companies being required to hold more HQLA than would be required under the Basel III LCR.  

More specifically, a covered company calculates its peak net outflow day excluding non-maturity outflows and all other outflows other than from brokered deposits for retail customers, unsecured wholesale funding that is not an operational deposit, secured funding and asset exchanges, foreign central bank borrowing, and outflows not otherwise specified in the rule that have a specified maturity (“Maturity Outflows”), with mirror inclusions and exclusions for inflows. Non-maturity unsecured wholesale funding that is not an operational deposit from financial sector entities (or that does not fit into any of the other category for unsecured wholesale funding), secured funding and asset exchanges, and foreign central bank borrowings are deemed under the Final Rule to mature on the first calendar day after the calculation date and therefore are considered Maturity Outflows and incorporated into the peak-day calculation. The peak-day amount is the day with the highest net cumulative Maturity Outflows. Next, the covered company determines the add-on amount, which is the difference between the peak-day amount and the net cumulative Maturity Outflow amount on the last day of the 30-calendar-day period (or zero, if the net cumulative outflow amount on the last day is less than zero). The 75% cap on inflows does not apply to the calculation of net cumulative Maturity Outflows for purposes of the add-on calculation.  

To determine the total net cash outflow amount, the covered company aggregates the Maturity Outflows (that is, the transactions included in the peak-day calculation and, therefore, in the add-on) and the non-maturity outflows (that is, the transactions excluded from the peak-day calculation and, therefore, from the
add-on) and similarly aggregates the corresponding inflows, subtracts inflows from outflows, with inflows subject to the 75% cap, and then adds the add-on amount.

**Maturity Assumptions.** In addition to eliminating the “first day” assumption for all transactions and instruments with no contractual maturity, the Final Rule refines several other maturity assumptions. For example, the Final Rule:

- Clarifies that certain open maturity transactions, such as non-maturity deposits at other financial entities and secured lending transactions, mature on the first calendar day after the calculation date, eliminating the uncertainty as to whether inflows from these open maturity transactions may be included in covered companies’ net cash outflow calculations.
- Revises the assumed maturity of structured transactions so that these commitments are assumed to occur on the actual scheduled maturity date rather than on the first day of the 30-calendar-day stress period, as under the Proposed Rule.
- Distinguishes between brokered deposits subject to withdrawal penalties and brokered deposits with no contractual withdrawal right. Brokered deposits that can only be withdrawn upon death or incompetence are assumed to mature on their scheduled maturity dates, whereas brokered deposits that may be withdrawn with penalties are treated as not having a maturity date and are subject to the assumptions for non-maturity transactions.

**Operational Deposits.** In response to commenters’ concerns, the Final Rule includes several changes to the definition of operational deposits and the corresponding definition of operational services. Specifically, the Final Rule:

- Provides more granular maturity determinations for options based on the type of option and holder of the option and excludes call options on callable bonds with a maturity of more than one year and the option is not effective for six months after issuance.
- Revises the definition of operational deposits to mean unsecured wholesale funding that is *necessary* to provide operational services. In comparison, the Proposed Rule defined operational deposits as unsecured wholesale funding that is *required* to provide operational services. Commenters argued for this change in order to better align the definition with industry practices and to capture operational deposits that are functionally necessary for the provision of operational services although not contractually required.
- Includes operational deposits necessary for the provision of operational services where the covered company is serving in an agent or administrator capacity. The Proposed Rule was limited to situations where a covered company served as an independent third-party intermediary.
- Expands the list of operational services that qualify as an operational deposit to include the “[a]dministration of payments and cash flows related to safekeeping of investment assets, not including the purchase or sale of assets.” The Agencies rejected suggestions to include other services such as trustee services, collateral management services and the settlement of foreign exchange transactions. The Final Rule also clarifies the transfer of capital distributions along with recurring contractual payments qualify as operational services.

The Final Rule also modifies several of the operational requirements that a deposit must meet to be considered an operational deposit. Notably, the Final Rule:
Requires that operational services, rather than the operational deposit as provided in the Proposed Rule, be provided pursuant to a written agreement. As commenters emphasized, this change more closely aligns the requirement with industry practice, as operational deposits are often held as demand deposits not subject to notice or termination restrictions whereas operational services are provided pursuant to a written contract with notice and termination provisions. The Final Rule also allows this requirement to be satisfied if a customer bears significant switching costs to obtain operational services from another provider in addition to contractual termination costs.

Eliminates the requirement that an operational deposit not have significant volatility in its average balance. Commenters were confused by this requirement, questioning how an average balance could be volatile since averaging by definition eliminates variability. However, the Final Rule does require covered companies to take into account the volatility of a deposit’s average balance in order to identify any excess amount which must be excluded from the operational deposit amount.

Clarifies that covered companies will be required to develop their own methodology for identifying deposits that are in excess of the amount necessary to provide operational services (and therefore excluded from treatment as operational deposits), which may aggregate on a customer basis or service basis as long as the methodology remains sufficiently granular to assess the risk of withdrawal in an idiosyncratic stress. In addition, covered companies must maintain appropriate documentation in support of their assumptions underlying any aggregation of deposits.

Defines prime brokerage services by the type of service provided rather than exclusively by the type of counterparty, as in the Proposed Rule, to identify services excluded from operational deposits, which effectively broadens the services that will fall within the scope of operational services.

Removes the phrase “correspondent banking” from the description of deposits owned by another depository institution and temporarily placed in an overnight deposit with a covered company which must be excluded from operational deposits. This change was made to clarify that not all banking arrangements with correspondents are excluded from operational deposits.

Segregated Accounts. The Final Rule, unlike the Proposed Rule, recognizes inflows from the release of assets held in segregated accounts in accordance with regulatory requirements for the protection of customer trading assets, such as the SEC’s Rule 15c3-3. In general, assets are released from such accounts to the broker-dealer when the broker-dealer recalculates the amounts it must hold in the segregated account (that is, the amount it must reserve to ensure it has sufficient funds to satisfy the obligations of its customers) and there is a decrease in the net amount the broker-dealer must reserve.

In order to include such assets in inflows under the Final Rule, a covered company must determine the anticipated amount of assets that will be needed to be held by the covered company 30 calendar days from a calculation date, assuming that customer cash and collateral positions have changed consistent with the outflow and inflow calculations required under the Final Rule (as applied to the transactions affecting the calculation of the segregated balance). If the future balance is less than the calculation date balance, then the inflow amount is the value of assets that would be released as of the calculation date. For purposes of the maturity determination, the inflow is deemed to occur on the date the broker-dealer
would next calculate its segregated account requirement. This inflow remains subject to the requirement that aggregate inflows are capped at 75% of aggregate outflows.

Commitments. The Agencies also clarified the requirements and outflow rates for liquidity and credit facility commitments. The Final Rule:

- Assigns outflow rates to commitments to special-purpose entities (“SPEs”) depending on the purpose of the SPE. In contrast, the Proposed Rule would apply a blanket 100% outflow rate to all SPEs. Under the Final Rule, committed credit and liquidity facilities to SPEs that issue securities or commercial paper will still be subject to a 100% outflow rate. However, for SPEs that do not issue securities or commercial paper, the outflow rate is assigned on the basis of the underlying customer, as follows:

  - The outflow rate for a committed credit facility extended by the covered company to an SPE that is a consolidated subsidiary of a wholesale customer or counterparty that is not a financial-sector entity is 10% of the undrawn amount;
  - The outflow rate for a committed liquidity facility extended by the covered company to an SPE that is a consolidated subsidiary of a wholesale customer or counterparty that is not a financial-sector entity is 30% of the undrawn amount;
  - The outflow amount for a committed credit facility extended by the covered company to an SPE that is a consolidated subsidiary or a financial-sector entity is 40% of the undrawn amount; and
  - The outflow amount for a committed liquidity facility extended by the covered company to an SPE that is a consolidated subsidiary of a wholesale customer or counterparty that is not a financial-sector entity is 100% of the undrawn amount.

- Confirms that letters of credit issued by a covered company that meet the definition of credit facility or liquidity facility will be considered as such for LCR purposes.

- Adopts the approach in the Proposed Rule of treating financing arrangements that exhibit characteristics of both credit and liquidity facilities as liquidity facilities. The Agencies favored a more conservative approach than the Basel Committee’s approach, which treats undrawn amounts under multi-purpose facilities as credit facilities. The Agencies expressed concern about the challenges of identifying which portion of a facility should be treated as a credit facility or a liquidity facility.

The Final Rule clarifies that the outflow rate for the undrawn amount of committed credit and liquidity facilities extended by a covered company to SPEs should be applied on a “look-through” basis to the underlying customer. For example, liquidity facilities extended to an SPE that is a wholesale customer or counterparty are assigned a 30% outflow rate whereas credit and liquidity facilities extended to an SPE that issues commercial paper or securities are assigned a 100% outflow rate.

Retail Funding Outflow Amount. In response to comments on retail funding outflow amounts, the Final Rule:

- Revises the outflow rate from 100% to 20% for fully insured deposits placed at the covered company by a third party on behalf of a retail customer or counterparty that are not brokered deposits, provided that the retail customer or counterparty owns the account, and to 40% for partially insured deposits under the same circumstances.
Changes the outflow rate from 100% to 40% for all other funding from a retail customer or counterparty that is not a retail deposit, a brokered deposit provided by a retail customer or counterparty or a debt instrument issued by the covered company that is owned by a retail customer or counterparty.

Treats living or testamentary trusts established for the benefit of natural persons that do not have a corporate trustee and that terminate within 21 years and 10 months after the death of grantors or beneficiaries of the trust living on the effective date of the trust or within 25 years, in the case of states with the rule against perpetuities, as retail customers.

**Retail Brokered Deposits.** With respect to retail brokered deposits, the Final Rule:

- Provides separate outflow rates for non-maturity brokered deposits in transactional accounts based on the extent of deposit insurance, whereas the Proposed Rule would have applied a blanket 100% outflow rate. Retail brokered deposits held in a transactional account with no contractual maturity are subject to a 20% outflow rate if the entire amount is covered by deposit insurance and a 40% outflow rate if partially insured. This category of outflows captures, for example, non-maturity affinity group referral deposits and third-party marketer deposits where the deposit is held in a transactional account with the bank.
- Retains the distinction between affiliate and non-affiliate sweeps in applying outflow rates to brokered deposits. The Agencies rejected comments calling for the same treatment of affiliate and non-affiliate sweeps, concluding that affiliate sweeps are more stable and reflect established relationships with retail customers.

**Deposits Held As Fiduciary.** The Final Rule clarifies the treatment of deposits held by a fiduciary or agent on behalf of a retail customer or counterparty. Specifically, the Final Rule:

- Confirms that brokered deposits held by a fiduciary or an agent on behalf of a retail customer or counterparty are subject to the outflow rate of non-maturity brokered deposits in a transactional amount, reciprocal deposits, brokered sweep deposits or any other type of brokered deposits.
- Specifies that deposits held as fiduciary that do not qualify as brokered deposits are subject to (i) a 20% outflow amount where the retail customer or counterparty owns the account and the entire amount is covered by deposit insurance and (ii) a 40% outflow amount where the retail customer or counterparty owns the account but less than the entire amount is covered by deposit insurance.

**Collateralized Deposits.** The Final Rule assigns outflow rates to all secured deposits, including collateralized public sector and corporate trust deposits, with a maturity within the 30-calendar-day stress period based on the quality of the collateral used to secure the deposits. Secured deposits secured by Level 1 liquid assets will be assigned a 0% outflow rate while deposits secured by Level 2A liquid assets will be assigned a 15% outflow rate. The outflow rate for secured deposits will not be greater than the equivalent outflow rate for an unsecured deposit for the same counterparty.

**Secured Funding Transactions.** The Final Rule caps the outflow rate for secured funding transactions at the outflow rate applicable to an equivalent wholesale unsecured transaction that is not an operational deposit from the same counterparty. However, this lower outflow rate is not applicable in instances where
the secured funding transaction is secured by collateral received by the covered company under a secured lending transaction or asset exchange.

There are several areas relating to net cash outflows where the Agencies made no changes – or provided only minor clarifications – despite significant industry comment. For example:

**Prime Brokerage.** The Final Rule does not expand the adjustments made in the Proposed Rule to accommodate some unique characteristics of prime brokerage services. Like the Proposed Rule, the Final Rule applies a 50% (rather than a 100%) outflow rate to customer short positions that are closed if the customer’s position is covered by another customer’s non-HQLA collateral. Application of a lower outflow rate reflects the relationship between the transactions and the fact that customers in practice as well as under the terms of their agreements would not be able to close out all short positions without taking corresponding steps to reduce leverage. The Final Rule does not extend this lower 50% outflow rate to customer short positions that are covered in other manners (e.g., by another customer’s HQLA collateral or the firm’s internal coverage positions).

Furthermore, the preamble to the Final Rule specifically notes the following:

- margin loans with terms that extend beyond the 30-calendar-day time horizon cannot be treated as inflows even if the loans are treated as overnight transactions and due on demand if the conditions of the term margin loan are not satisfied;
- inflows are subject to the 75% cap even in circumstances where positions are the equivalent of a matched book (e.g., inflows from loans of securities to the bank that cover customer short positions); and
- if collateral from a secured lending transaction is rehypothecated to secure a secured funding transaction, an inflow may only be recognized if both transactions mature within the 30-calendar-day period at the maturity date of the secured lending transaction (which may be no earlier than that of the secured funding transaction).

**Derivatives.** The treatment of derivatives remains largely unchanged from the Proposed Rule, including the provisions relating to collateral outflow amounts, which were the subject of significant industry comment. With respect to collateral outflow amounts, the Final Rule provides the following clarifications:

- Derivative collateral potential valuation changes in Section 32(f)(2):
  - The provision applies only to collateral securing derivatives transactions; and
  - The outflow rate applies to netted collateral but only if the collateral can be netted under the same qualifying master netting agreement.
- The collateral substitution requirement in Section 32(f)(5) applies only to collateral a covered company has posted to a counterparty as of the calculation date and not collateral that it could repost to a counterparty after a collateral substitution has taken place.
- Only variation margin and not initial margin must be included in the potential derivative valuation change requirement in Section 32(f)(6) (the two-year look-back requirement).
Debt Security Outflow Amount. The Final Rule tracks the Proposed Rule in its treatment of a covered company’s debt securities where the covered company is the primary market-maker, applying a 3% outflow rate for all debt securities that are not structured securities that mature outside of the 30-calendar-day stress period and a 5% outflow rate for structured debt securities that mature outside of the 30-calendar-day stress period.

D. MODIFIED LCR

The Final Rule retains the modified LCR standard for bank holding companies and savings and loan holding companies with at least $50 billion in total consolidated assets that are not internationally active and do not have significant insurance or commercial operations. The Proposed Rule would have applied a 21-calendar-day stress period for covered companies subject to the modified LCR rather than the 30-calendar-day stress period for the full LCR. Commenters expressed concerns about the operational and technological challenges of using a 21-calendar-day period because the timeframe is idiosyncratic and does not correspond to existing systems and processes. In response, the Final Rule eliminates the 21-calendar-day period and applies a full 30-calendar-day stress period to the modified LCR. To adjust for the full calendar-day stress period, outflow rates will be capped at 70% of the outflow rate that applies to the full LCR.

As noted above, the initial compliance date for institutions subject to the modified LCR is delayed until January 2016 and these institutions will only be required to calculate their LCR on a monthly basis.

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ENDNOTES


5 The Final Rule at 18.


7 The Final Rule does not explicitly require that (i) Reserve bank balances, (ii) foreign withdrawable reserves or (iii) securities issued by, or unconditionally guaranteed as to the timely payment of principal and interest by, the U.S. Department of the Treasury be liquid and readily marketable in order to be included in Level 1 liquid assets. However, these assets are inherently stable and liquid, justifying their inclusion in Level 1 HQLA.

8 In response to industry comment, foreign currency exchange derivative transactions that involve a full exchange of contractual cash principal amounts in different currencies within the same business day may be included in the net derivative cash outflow amount as a net amount, which means that the inflow leg of the transaction effectively is not subject to the 75% cap on inflows.
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APPENDIX: INTRODUCTION TO THE LCR

The LCR is generally defined as the ratio of a banking organization’s stock of high-quality liquid assets divided by its total net cash outflows over the next 30 calendar days under stressed conditions. Once fully phased-in, the ratio must be at least 100% such that the stock of high-quality liquid assets is always at least equal to total net cash outflows.

HQLA alone makes up the numerator of the LCR. In order to qualify as HQLA, assets must be “liquid and readily-marketable,” meaning the asset must be traded in an active secondary market with more than two market-makers, a large number of other market participants, timely and observable market prices and a high trading volume. The Final Rule also outlines operational requirements for assets includible as HQLA. These requirements are designed to ensure that a banking organization could convert its liquid assets into cash during periods of stress and therefore be able to fulfill its obligations. Operational requirements include:

- the operational capability to monetize the HQLA;
- the implementation of policies requiring all HQLA to be under the control of a banking organization’s management team responsible for managing liquidity risk and the segregation of HQLA from other assets or the ability to monetize HQLA without undermining other business or risk management strategies;
- the inclusion of the amount of cash outflow that would result in the termination of any specific transaction hedging HQLA in a banking organization’s total new cash outflow; and
- the implementation and maintenance of policies and procedures to allow a banking organization to assess the daily composition of its HQLA.

The Final Rule divides HQLA into three categories: Level 1, Level 2A and Level 2B liquid assets.

- **Level 1 Liquid Assets.** Level 1 liquid assets are the highest quality and most liquid type of HQLA. An unlimited amount of Level 1 liquid assets may be counted towards HQLA at their full fair values. Level 1 liquid assets include cash; most central bank reserves; securities issued by, or unconditionally guaranteed as to the timely payment of principal and interest by, the U.S. Department of the Treasury; securities issued by other U.S. Government agencies whose obligations are fully and explicitly guaranteed by the full faith and credit of the U.S. government; and certain other sovereign and multilateral organizational securities.

- **Level 2A Liquid Assets.** Level 2A liquid assets consist of relatively stable and liquid assets, but are subject to a 15% haircut and the overall limitation that Level 2A and Level 2B liquid assets combined cannot exceed 40% of the total stock of HQLA. Level 2A liquid assets include claims issued and guaranteed by a U.S. Government Sponsored Enterprise (GSE), including the Federal Home Loan Mortgage Corporation, the Federal National Mortgage Association, the Farm Credit System and the Federal Home Loan Bank System, provided that the claims are investment grade; and certain claims guaranteed by a sovereign entity or multilateral development bank. Notably, the Final Rule excludes all corporate debt securities from Level 2A liquid assets, unlike the Basel III LCR which includes liquid corporate debt securities in Level 2A liquid assets provided that they have a credit rating of at least AA- and are not issued by a financial institution.
Level 2B Liquid Assets. Level 2B liquid assets are the riskiest assets that may still be counted as part of HQLA and are subject to a 50% haircut and subject to the limitation that Level 2B liquid assets cannot exceed 15% of the total stock of HQLA. Level 2B liquid assets would include certain corporate debt securities and publicly traded shares of common stock, subject to several restrictions. Under the Final Rule, Level 2B liquid assets would not include residential mortgage-backed securities, whereas the Basel III LCR generally permits their inclusion in Level 2B liquid assets subject to a 25% haircut.

The caps on Level 2 liquid assets – 40% on total HQLA for Level 2 and 15% for Level 2B – are calculated both before and after giving effect to an assumed unwind of any HQLA-for-HQLA transaction (such as repurchase or collateral swap transactions) that would occur within the next 30 days. The lower of the two calculations is used for the LCR calculation. Under the Final Rule, the denominator of the LCR consists of the net cash outflow over the calculation period plus the daily peak-day add-on approach with respect to certain types of transactions. See “Total Net Cash Outflows – Peak-Day” above for a description of this add-on approach. In contrast, the Basel III LCR calculates total net cash outflows over the 30-day stress period without any daily or peak-day add-on. The total net cash outflow amount for each of the next 30 calendar days would be (i) the sum of the cumulative stressed outflow amounts, less (ii) the sum of the cumulative stressed inflow amounts.

Like the Basel III LCR, cumulative stressed inflow amounts are capped at 75% of cumulative stress outflow amounts. This ensures that banking organizations hold a minimum amount of HQLA, even if their contractual inflows and outflows are perfectly matched.

Total outflows includes instruments that mature within 30 calendar days, instruments that lack a contractual maturity date and retail deposits and certain brokered deposits that mature more than 30 calendar days after the calculation date. Total inflows would include instruments that mature within 30 calendar days but would exclude instruments without a contractual maturity date.

Consistent with the Basel III LCR, the Final Rule places different types of outflows into categories and assigns an outflow rate from 0% to 100% to each category. The outstanding balance of each category is multiplied by the applicable outflow rate to calculate the outflow rate used in the denominator of the LCR.

Like cash outflow amounts, different types of inflows are placed in categories and assigned inflow rates specified in the proposal. Cash inflow amounts are then calculated by multiplying the outstanding balances of contractual receivables and other cash inflows as of the calculation date by the applicable inflow rates. As mentioned above, cash inflows are capped at 75% of expected cash outflows, even if actual cash inflows match cash outflows. Therefore, total cash inflow rates are calculated as the lesser of (i) the sum of cash inflow amounts and (ii) 75% of expected cash outflows. Cash inflow amounts would include net derivatives, retail contractual payments, unsecured wholesale inflows, securities and secured lending transactions.
The Final Rule requires a banking organization to notify its applicable federal banking agency if its LCR falls below the minimum requirement on any business day. If a banking organization’s LCR falls below the minimum requirement for three consecutive business days or the agency determines that the covered company would otherwise be materially noncompliant with the Final Rule, the relevant company would be required to submit a plan for remediation. The Agencies, at their discretion, could also take supervisory or enforcement action against a banking organization experiencing an LCR shortfall.