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Federal Reserve Proposes Bank Liquidity Requirements That Exceed the Basel III Standard

The Federal Reserve Board (Board) today approved a proposed rule requiring larger U.S. banking organizations maintain liquid assets in an amount sufficient to meet the liquidity requirements determined under the rule, referred to as the liquidity coverage ratio (LCR).

The LCR rule sets forth requirements for calculating the expected amount of net cash outflow during the relevant test period, identifying the unencumbered high quality liquidity assets (HQLA) that would be held to meet the LCR and determining that 100 percent of the net cash outflow is covered by HQLA.

For more details, see the proposed LCR rule, accompanying Board staff memorandum and Board Gov. Daniel Tarullo's opening remarks.

The LCR rule would generally apply to all internationally active U.S. banking organizations (*i.e.*, banking organizations with $250 billion or more in total assets or $10 billion or more in on-balance sheet foreign exposure), systemically important financial institutions that do not have substantial insurance activities, and their consolidated subsidiary depository institutions that have more than $10 billion in assets.

In addition, a modified LCR requirement would apply to bank holding companies and savings and loan holding companies without significant insurance or commercial operations that have $50 billion or more in consolidated assets but are not one of the organizations described above. The essential difference with respect to the modified LCR is that the LCR would be tested over a 21-day period instead of the 30-day period used for other institutions.

In his opening remarks, Gov. Tarullo characterized the proposal as a "super-equivalent" to the LCR standard issued by the Basel Committee on Banking Supervision (Basel Committee) in January 2013. In particular, he noted that while generally consistent with the Basel Committee's LCR standard, the U.S. LCR proposal is stricter is some respects. Three key differences are:

	Basel Committee's LCR	U.S. LCR proposal
Transitional period from introduction to complete implementation	Jan. 1, 2015: 60 percent compliance Jan. 1, 2019: 100 percent compliance	Jan. 1, 2015: 80 percent compliance Jan. 1, 2017: 100 percent compliance
HQLA types required to meet the LCR rule	More expansive definition	Excludes assets included in Basel Committee's LCR, such as private label MBS, covered bonds and certain municipal obligations
30-day period for testing compliance with the LCR rule requirement	Hold HQLA against net cumulative cash outflow as of the end of the 30-day liquidity stress period	Hold HQLA against largest net cumulative cash outflow day within a 30-day liquidity stress period, ensuring compliance with the highest LCR occurring during that period

If you have any questions regarding the matters discussed in this memorandum, please contact the following attorneys or call your regular Skadden contact.

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Gov. Tarullo noted that the LCR by itself is not sufficient to address potential liquidity problems at large banking organizations and work must continue on the Net Stable Funding Ratio (NSFR), which is a complementary measure that would create a one-year structural funding requirement. He indicated that once the Basel Committee finishes its work on the NSFR standard, the Board would likely propose a U.S. rule.

He stated that "[he] believe[d] that among our highest remaining priorities should be more macroprudentially informed regulatory measures to address the tail risk event of a generalized liquidity stress by forcing some internalization of the systemic costs of this form of financial intermediation." Board staff noted that the U.S. LCR proposal and the U.S. Basel III capital rules do not address all macroprudential risks, such as those presented by short-term wholesale funding, money market mutual funds and the shadow banking system. Staff noted that they were exploring other tools to address these risks, but are particularly focused on (i) strengthening the bank liquidity regime to address these risks, (ii) imposing a capital surcharge for large banking organizations and (iii) imposing margin requirements on certain securities transactions.

Regarding the capital surcharge, during the Board's meeting to approve the U.S. Basel III capital rules in July, Gov. Tarullo noted that he expected the Board to issue an advanced notice of proposed rulemaking that would seek comment on additional measures for banking organizations that rely on short-term wholesale funding, including whether such firms should have to hold additional capital.

Board staff also stated that they were working on developing a reporting template to standardize the LCR calculation across the large banking organizations. Staff indicated that the large banking organizations are participating in a quantitative impact study relating to this template. The staff anticipated including reporting requirements with the LCR rule if it becomes final.