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COMMENTARY

Federal Bank Regulators Propose New Long-Term Liquidity Standards

The Board of Governors of the Federal Reserve System ("Board"), Office of the Comptroller of the Currency ("OCC"), and Federal Deposit Insurance Corporation ("FDIC") (collectively, the "Agencies") each recently released a joint proposed rule, *Net Stable Funding Ratio: Liquidity Risk Management Standards and Disclosure Requirements* (the "Proposal"), which would set quantitative long-term liquidity requirements for large and internationally active U.S. bank holding companies ("BHCs") and their consolidated bank subsidiaries in an effort to reduce the likelihood that disruptions to normal sources of funding will harm liquidity.[1]

The Proposal is the long-term liquidity complement to the liquidity coverage ratio ("LCR"),[2] the short-term liquidity rule adopted by the Agencies in September 2014. Together, the Proposal and the LCR rule are designed to strengthen liquidity risk management practices and improve the liquidity positions of large banking organizations.

Comments are due on August 5, 2016.

The Proposal is Part of a Continuing Regulatory Focus on Liquidity Measures

During the financial crisis, some large banking organizations did not have access to sufficient sources of liquidity due to an overreliance upon short-term, high-risk funding, an underinvestment in liquid assets, or both. The lack of sufficient liquidity caused governments around the world to step in to provide support to maintain financial stability.

Since the financial crisis, national and international regulators have taken several significant steps to strengthen banking organizations' liquidity risk management and positions. The LCR rule established the first standardized minimum liquidity requirements for large and internationally active financial institutions. The LCR rule requires large financial institutions to hold a minimum amount of high-quality liquid assets that can be readily converted into cash to meet net cash outflows over a 30-calendar-day period.[3]

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Last fall, the Board proposed a long-term debt requirement and a total loss-absorbing capacity[4] requirement that would apply to U.S. global systemically important banking institutions ("G-SIBs") and the U.S. operations of foreign G-SIBs, requiring them to have sufficient amounts of equity and eligible long-term capital debt to improve their ability to absorb significant losses and withstand financial stress.[5] In August 2015, the Board adopted a risk-based capital surcharge for G-SIBs, which is calculated to each institution's overall systemic risk, including its reliance on short-term wholesale funding.[6]

Earlier, in March 2014, the Board adopted a set of comprehensive macroprudential requirements mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010[7] ("Dodd-Frank Act") that included standards for risk management, liquidity risk management, and stress testing for large, internationally active BHCs.[8]

Like many of the standards that came before it, the Proposal is heavily influenced by the international framework set by the Basel Committee on Banking Supervision ("Basel Committee") and is tailored to the systemic footprint of companies, placing more stringent requirements on larger, internationally active firms whose viability is most interconnected with the viability of other financial institutions and whose distress would threaten the global economy as a whole.

Overview of the Proposal

The Proposal would apply to large and internationally active U.S. bank holding companies and depository institutions with more than $250 billion in total consolidated assets or $10 billion or more in total on-balance-sheet foreign exposures ("covered companies"), as well as those banking organizations' subsidiary depository institutions that have total consolidated assets of $10 billion or more.[9] The Proposal would apply a modified version of the net stable funding ratio ("NSFR") to U.S. BHCs with less than $250 billion, but more than $50 billion, in total consolidated assets, and less than $10 billion in on-balance-sheet foreign exposure.[10] The Proposal would not apply to BHCs with less than $50 billion in total consolidated assets and would not apply to community banks.

Covered companies would be required to maintain a stable funding profile over a one-year time horizon and to rely on stable funding sources such as equity, deposits, and long-term debt rather than more volatile short-term funding in order to help ensure that each company can survive one year of financial stress.

The Proposal would require "advanced approaches" BHCs—those with more than $250 billion in assets and more than $10 billion in foreign exposures—to cover 100 percent of their obligations for a year, whereas smaller companies with between $50 billion and $250 billion in assets would be required to cover only 70 percent of their obligations for that same time period.

According to the Preamble to the Proposal, larger internationally active banking organizations "tend to have larger and more complex liquidity profiles," which require "heightened measures to manage their liquidity risk."[11] Because these large and complex banking organizations are often interconnected with other large and complex banking organizations, "threats to the availability of funding to larger firms pose greater risks to the financial system and economy."[12]

Covered companies would be required to publicly disclose the company's NSFR and the components of its NSFR each calendar quarter, and covered companies that fall short of the requirement would be required to submit an improvement plan.

Calculating the NSFR. The NSFR is a quantitative metric designed to measure the stability of a covered company's funding profile.

A covered company's NSFR would be expressed as a ratio of its available stable funding ("ASF") (the numerator of the ratio) to its required stable funding ("RSF") (the denominator of the ratio). The Proposal would require a covered company to maintain an amount of ASF that is no less than the amount of its RSF.[13] The Proposal would require covered companies to maintain an NSFR, on a consolidated basis, that is equal to or greater than 1.0.

A covered company's ASF amount would be a weighted measure of the stability of the company's funding over a one-year time horizon. A covered company would calculate its ASF amount by applying standardized weightings, called "ASF

factors," to its equity and liabilities based on their expected stability. Similarly, a covered company would calculate its RSF amount by applying standardized weightings, called "RSF factors," to its assets, derivative exposures, and commitments based on their liquidity characteristics. These characteristics would include credit quality, tenor, encumbrances, counterparty type, and characteristics of the market in which an asset trades, as applicable.[14]

The assigned ASF and RSF factors in the Proposal are generally consistent with the assigned ASF and RSF factors in the Basel Committee's Basel III NSFR.[15] The Proposal would assign the highest weight—a 100 percent ASF factor—to regulatory capital elements and long-term liabilities, a 95 percent ASF factor to stable retail deposits, a 90 percent ASF factor to other retail deposits, a 50 percent ASF factor to certain unsecured wholesale funding transactions and most retail broker deposits, and a 0 percent weight to certain short-term funding from central banks.[16]

The Proposal would assign a 0 percent RSF factor to certain assets that can be directly used to meet financial obligations, such as cash, reserve bank balances, and claims on reserve banks and foreign central banks that mature in less than six months. The Proposal would give a 5 percent RSF to unencumbered level 1 liquid assets, such as U.S. Treasury securities and other assets with high credit quality and favorable market liquidity characteristics. Certain secured lending transactions with a financial sector entity that mature within six months would be assigned a 10 percent RSF, and unencumbered level 2A liquid assets, such as obligations issued or guaranteed by government-sponsored enterprises, would be assigned a 15 percent RSF.

Certain secured lending transactions that mature in more than six months (but less than one year), operational deposits held at financial sector entities, and loans to retail customers and counterparties that mature in less than one year would be included in the list of assets, commitments, and derivatives assigned a 50 percent RSF. Retail mortgages and certain secured lending transactions that mature in more than one year with risk weights lower than 50 percent and 20 percent respectively would be assigned a 65 percent RSF. Retail mortgages and certain secured lending transactions that mature in more than one year with risk weights higher than 50 percent and 20 percent respectively would be assigned an 85 percent RSF, in addition to publicly traded non-HQLA common equity shares and commodities. Loans to financial institutions that mature in one year or more, assets deducted from regulatory capital, non-public common equity shares, unposted debits, and certain trade date receivables would be assigned a 100 percent RSF.[17]

The Proposal Would Set a Modified NSFR for Smaller Companies. A version of the NSFR requirements would apply to smaller BHCs[18] with between $50 billion and $250 billion in total consolidated assets and total on-balance-sheet foreign exposure of less than $10 billion ("modified NSFR holding company"). A modified NSFR holding company would be required to maintain a lower minimum amount of stable funding, equivalent to 70 percent of the amount that would be required for a covered company.[19]

According to the Proposal, although modified NSFR holding companies "generally are smaller in size, less complex in structure, and less reliant on riskier forms of funding than covered companies, these modified NSFR holding companies are nevertheless important providers of credit in the U.S. economy," and therefore the Agencies are proposing a modified NSFR that "is tailored to the less risky liquidity profile of these companies."[20]

Other than a lower RSF requirement and a longer transition period, the proposed modified NSFR requirement would be identical to the proposed NSFR requirement for covered companies, including the public disclosure requirements.

The Proposal Would Establish New Disclosure Requirements. The Proposal would require a covered company to take several steps if its NSFR fell below 1.0, including notifying its primary federal regulator within 10 days of the shortfall and submitting a remediation plan.[21] The Proposal would not prescribe a particular supervisory response to address a violation of the NSFR requirement. Instead, the Proposal would grant flexibility for the Agencies to respond based on the circumstances of a particular case. Potential supervisory responses could include an informal supervisory action, a cease-and-desist order, or a civil money penalty.[22] In addition, a covered company would be required to publicly disclose its NSFR and NSFR components each calendar quarter to

facilitate understanding of its calculations and results.[23] Disclosures could be made on the company's website, in a public financial report, or in a public regulatory report.

Effective Dates. The Proposal would become effective on January 1, 2018. A company that becomes subject to the Proposal after that date would be required to comply with the NSFR requirement beginning on April 1 of the following year. The Proposal uses the following example: If a BHC becomes subject to the Proposal on December 31, 2020 because it reports on its year-end Consolidated Financial Statements for Holding Companies (FR Y-9C) that it has total consolidated assets of $251 billion, that BHC would be required to begin complying with the proposed NSFR requirement on April 1, 2021.[24]

The Proposal would grant a longer transition period for modified NSFR holding companies than for covered companies. A modified NSFR holding company that becomes subject to the Proposal after the January 1, 2018 effective date would be required to comply with the proposed modified NSFR requirement one year after the date that it meets the applicable thresholds.[25]

The Basel Committee's Influence. Following the financial crisis, the Basel Committee began revising its existing capital adequacy guidelines and developed new capital and liquidity requirements ("Basel III") designed to strengthen the regulatory capital regime for internationally active banks.[26] In 2011, as part of the Board's initial proposed macroprudential requirements mandated by the Dodd-Frank Act, the Board announced that it would implement substantially all of the Basel III capital rules.[27]

In October 2014, the Basel Committee published its NSFR standard, which requires all internationally active banking organizations on a consolidated basis, regardless of size, to retain stable funding for 100 percent of their obligations for one year.[28] The standard could potentially apply to other banks and to any subset of entities of internationally active banks depending on how a jurisdiction adopts the framework. The Basel Committee's NSFR is the longer-term equivalent of the Basel Committee's LCR.[29] In this respect, there is a clear parallel similar to the Proposal and the LCR rule.

The Proposal is largely the same as the Basel Committee's NSFR, except for the largest difference—the scope of companies to which it applies. Like many of the macroprudential requirements that resulted from the Dodd-Frank Act and the U.S. implementation of the Basel Committee's framework, the Proposal differentiates between the largest banks and smaller institutions. For example, under the Proposal, the largest covered companies would be required to maintain stable funding for 100 percent of their obligations for one year, while smaller covered companies would be required to cover 70 percent.

Lawyer Contacts

For further information, please contact your principal Firm representative or one of the lawyers listed below. General email messages may be sent using our "Contact Us" form, which can be found at www.jonesday.com/contactus/.

Lisa M. Ledbetter
Washington
+1.202.879.3933
lledbetter@jonesday.com

Locke R. McMurray
New York
+1.212.326.3774
lmcmurray@jonesday.com

Brett P. Barragate
New York
+1.212.326.3446
bpbarragate@jonesday.com

Courtney L. Snyder
Pittsburgh
+1.412.394.7910
clsnyder@jonesday.com

Robert J. Graves
Chicago
+1.312.269.4356
rjgraves@jonesday.com

Endnotes

1 The Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation, *Net Stable Funding Ratio: Liquidity Risk Measurement Standards and Disclosure Requirements*, 81 Fed. Reg. 35123 (June 1, 2016) (to be codified at 12 C.F.R. part 249 (Board); 12 C.F.R. part 50 (OCC), 12 C.F.R. part 329) (FDIC)) (the "Proposal").

2 LCR is the ratio of liquid assets to projected net cash outflows. The Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation, *Liquidity Coverage Ratio: Liquidity Risk Measurement Standards*, 79 Fed. Reg. 61440 (Oct. 10, 2014), codified at 12 C.F.R. part 249 (Board), 12 C.F.R. part 50 (OCC), 12 C.F.R. part 329 (FDIC).

3 The LCR rule applies to all banking organizations with $250 billion or more in total consolidated assets or $10 billion or more in on-balance-sheet foreign exposure and to these banking organizations' subsidiary depository institutions that have assets of $10 billion or more. The rule applies a less stringent LCR to BHCs that do not meet these thresholds but have $50 billion or more in total assets. *Id.*

4 The Board of Governors of the Federal Reserve System, *Total Loss Absorbing Capacity, Long-Term Debt, and Clean Holding Company Requirements for Systemically Important U.S. Bank Holding Companies and Intermediate Holding Companies of Systemically Important Foreign Banking Organizations; Regulatory Capital Deduction for Investments in Certain Unsecured Debt of Systemically Important U.S. Bank Holding Companies*, 80 Fed. Reg. 74926 (Nov. 20, 2015) (to be codified at 12 C.F.R. parts 217 and 252).

5 Staff Memo to the Board, Notice of Proposed Rulemaking to Implement Liquidity Risk Standards for Certain FDIC Supervised Institutions (Apr. 26, 2016).

6 The Board of Governors of the Federal Reserve System, *Regulatory Capital Rules: Implementation of Risk-Based Capital Surcharges for Global Systemically Important Bank Holding Companies*, 80 Fed. Reg. 49082 (Aug. 14, 2015) (codified at 12 C.F.R. parts 208 and 217).

7 Public Law 111-203, 124 Stat. 1376 (2010).

8 The Board of Governors of the Federal Reserve System, *Enhanced Prudential Standards for Bank Holding Companies and Foreign Banking Organizations*, 79 Fed. Reg. 17240 (Mar. 27, 2014) (codified at Regulation YY, 12 C.F.R part 252).

9 Proposal at 35128.

10 The Proposal also applies the modified approach to savings and loan holding companies that have $50 billion or more in total consolidated assets and do not have significant insurance or commercial operations. *Id.*

11 *Id.*

12 *Id.*

13 *Id.* at 35132; 35134; 35140.

14 *Id*.

15 Basel Committee on Banking Supervision, *Basel III: the net stable funding ratio* (Oct. 2014).

16 *Id.* at 35135-40.

17 *Id.* at 35140-49.

18 The Modified NSFR would also apply to savings and loan companies without significant insurance or commercial operations that have $50 billion or more, but less than $250 billion, in total consolidated assets and less than $10 billion in total on-balance-sheet foreign exposure.

19 *Id.* at 35157.

20 *Id*. at 35157-58.

21 *Id*. at 35157.

22 *Id.*

23 *Id.* at 35158-61.

24 *Id.* at 35129.

25 *Id.* at 35158.

26 Basel Committee on Banking Supervision, *International Regulatory Framework for Banks*.

27 Board of Governors of the Federal Reserve System, Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies 77 Fed. Reg. 599, 602, 634 (Jan. 5, 2012).

28 Basel Committee on Banking Supervision, *Basel III: the net stable funding ratio* (Oct. 2014).

29 *Id.*

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