Securitization Perspectives: Final U.S. Liquidity Coverage Ratio

September 10, 2014

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Introduction

- On September 3rd, the Agencies adopted regulations implementing a liquidity coverage ratio (**LCR**) requirement that will test a bank's ability to withstand "liquidity stress periods" (the **Final Rule**).
- The objective is to ensure that a bank has enough high quality liquid assets (or **HQLA**) that can be immediately converted into cash to meet its liquidity needs during a prospective 30-day stress period. LCR compliance will be tested **daily**.
- The Final Rule applies to "**covered companies**", including:

  (i) banking organizations with $250 billion or more in total assets;
  (ii) banking organizations with $10 billion or more in on-balance sheet foreign exposures; and
  (iii) consolidated subsidiary depository institutions of these entities with $10 billion or more in consolidated total assets.

- A **modified version** of the LCR applies to bank holding companies with consolidated assets of $50 billion or more that are not covered companies.
- The Final Rule **does not apply** to foreign banking organizations or U.S. intermediate holding companies that are required to be established under Regulation YY.

Background

- The Basel Committee on Banking Supervision (**BCBS**) initially published international liquidity standards in December 2010 as part of the Basel III reform package and revised the LCR in January 2013 (the **Final Basel LCR Guidelines**).
- In October 2013, the Agencies initially proposed a rule to implement an LCR requirement in the United States (the **Proposed Rule**).
- The Final Rule implements the LCR requirement in a manner mostly consistent with the Final Basel LCR Guidelines - with some modifications to reflect the characteristics and risks of specific aspects of the U.S. market and U.S. regulatory framework. However, the Final Rule is **more stringent** than the Final Basel LCR Guidelines in several important areas.
- In response to **extensive industry comment**, the Final Rule incorporates a number of changes to the requirements set forth in the Proposed Rule. Several of those changes impact the securitization market.

Computation of LCR

Liquid assets held for operational liquidity needs that are unencumbered and otherwise unrestricted

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Greater of:
(i) unadjusted excess HQLA amount; and
(ii) adjusted excess HQLA amount

High Quality Liquid Assets

≥ 100%

Outflows from:
- Deposits (retail and wholesale)
- Other unsecured funding (retail and wholesale)
- **Sponsored structured transactions**
- Derivatives
- **Commitments**
- Collateral outflows
- Debt security outflows
- Secured funding and asset exchange outflows
- Other outflows

(At assumed outflow rates)

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Inflows (capped at 75% of Outflows) from:
- Net derivatives
- Retail and unsecured wholesale cash inflows
- Securities and securities lending cash inflows
- Secured lending and asset exchange inflows

(At assumed inflow rates)

Total Net Cash Outflows

The Numerator: Types of HQLA

The Final Rule's criteria and limitations surrounding HQLA are meant to ensure that a covered company's **HQLA amount only includes assets with a high potential to generate liquidity** through a sale or borrowing secured by those assets during a stress scenario.

Type of Liquid Asset	Description	Haircut	Cap
Level 1	Highest quality and most liquid assets *Example*: U.S. Treasury Securities	N/A	N/A
Level 2A	Relative price stability with significant liquidity *Example*: GSE Securities	15%	When combined with Level 2B Liquid Assets, can't exceed 40% of total HQLA
Level 2B	More price volatility and less liquidity *Examples*: Highly liquid investment grade corporate debt securities and exchange traded corporate equity securities	50%	Can't exceed 15% of total HQLA

Industry Advocacy: The Numerator

	Final Rule is Consistent with Proposed Rule	Industry Comment to Proposed Rule
GSE MBS	Treatment as Level 2A liquid assets provided for securities issued by, or guaranteed as to the timely payment of principal and interest by, a U.S. GSE that is (1) investment grade and (2) senior to preferred stock. GSE securities are subject to a 15% haircut and, coupled with other Level 2A and Level 2B liquid assets, a 40% cap of total stock of HQLA.	The Agencies should permit Level 1 treatment for mortgage-backed securities issued by Fannie Mae and Freddie Mac ("GSE MBS") at least for so long as Fannie Mae and Freddie Mac are operating under conservatorship or receivership or are otherwise effectively guaranteed by the U.S. government. If the Agencies are unwilling to afford Level 1 treatment, the Agencies should exclude GSE MBS from the 40% cap applied to other Level 2A assets.
Private-Label RMBS	Do not qualify for HQLA treatment.	Certain high credit quality RMBS should be afforded Level 2B liquid asset treatment. RMBS backed exclusively by Qualified Mortgages should qualify subject to a 25% haircut and all other RMBS should qualify subject to a 50% haircut.
Covered Bonds	Do not qualify for HQLA treatment.	Certain high credit quality covered bonds should be afforded Level 2B liquid asset treatment.
ABS	Do not qualify for HQLA treatment.	Certain high credit quality ABS should be included as Level 2B liquid assets so long as their liquidity characteristics mirror those of publicly traded corporate debt securities.

The Denominator: Calculation of Net Outflows

Proposed Rule: Net Cumulative Peak Day Approach

- The Proposed Rule would have required covered companies to calculate net outflows using a "**peak day**" approach. Under this approach, covered companies would have been required to hold HQLA against their **largest net cumulative cash outflow day** within a 30-day calculation period.

- The Proposed Rule would have required covered companies to assume that ***outflows* occur on the *earliest* possible date** and ***inflows* occur on the *latest* possible date** that they could occur during the 30-day calculation period.

The Denominator:
Calculation of Net Outflows (cont'd)

Final Rule: Add-On Approach

- The Final Rule replaces the "peak day" approach within an approach that measures **total net outflows** over the relevant 30-day calculation period with an **add-on** which requires the covered company to determine the **largest single day maturity mismatch between outflows and inflows that have set maturity dates** within the calculation period.

- The maturity mismatch is determined by calculating the difference between cumulative outflows and inflows that have set maturity dates during the period for each day during the period. The day with the largest difference is the net cumulative outflow peak day.

- The covered company then determines the difference between the peak day amount and the net cumulative outflow amount on the last day of the calculation period. **The greater of this difference and zero is the add-on.**

The Denominator: Maturity Assumptions

The Final Rule largely carries over the **conservative maturity assumptions** that were set forth in the Proposed Rule and clarifies some of those assumptions.

In general, the maturity of an instrument or obligation that would result in an **outflow amount** must be assumed to occur on the **earliest possible** contractual date and the maturity of an instrument or obligation that would result in an **inflow amount** must be assumed to occur on the **latest possible** contractual date.

With respect to outflow amounts:

- ➢ If an investor has an option to extend a maturity, the covered company must assume the option will not be exercised, and
- ➢ If the covered company has the option to reduce a maturity, the covered company must assume that it will not exercise that option unless:
    - (i) The original maturity of the obligation is greater than one year and the option does not go into effect for a period of 180 days following issuance of the instrument, or
    - (ii) the counterparty is a sovereign entity, a U.S. GSE, or a public sector entity.

The Denominator: Commitment Outflow Amount

The Final Rule's commitment outflow amount would capture the **undrawn portion of committed credit and liquidity facilities** provided by a covered company to its customers and counterparties that **could be drawn within 30 days** of the calculation date.

Term	Definition
Liquidity Facility	a legally binding agreement to extend funds at a future date to a counterparty that is made for the purpose of refinancing the debt of the counterparty when it is unable to obtain a primary or anticipated source of funding
Credit Facility	any other legally binding agreement to extend funds if requested at a future date (*e.g.*, revolving credit facility for general corporate or working capital purposes)
Committed	the **written** terms governing the facility prohibit a covered company from refusing to extend credit or funding under the facility (except where certain conditions by the terms of the facility have been met)
Mixed Use Facilities	facilities that have aspects of both credit and liquidity facilities constitute liquidity facilities for purposes of the LCR

The Denominator: Proposed Rule's Outflow Amounts for Undrawn Commitments

Customer Commitment Type	Outflow Amounts for Undrawn Commitments
Committed credit facilities to non-financial corporates	10%
Committed liquidity facilities to non-financial corporates	30%
Committed credit and liquidity facilities to depository institutions, depository institution holding companies and foreign banks (other than commitments to affiliated depository institutions, which are 0%)	50%
Committed credit facilities to non-bank financial institutions	40%
Committed liquidity facilities to non-bank financial institutions	100%
Committed credit and liquidity facilities to SPEs	**100%**

The Denominator: Industry Advocacy
Look Through Approach Proposal

- Chapman represented the **Structured Finance Industry Group** and the **Securities Industry and Financial Markets Association** (the **Associations**) in connection with a comment letter regarding the Proposed Rule submitted in January 2014.

- The Associations argued that bank customer securitization credit facilities are established as substitutes for, or complements to, traditional secured and unsecured revolving credit facilities.

- **The Associations proposed that the outflow amount for a bank customer securitization credit facility match the outflow amount that would apply to a credit facility extended directly to the bank customer.**

  - In other words, for these transactions, the Associations proposed that the outflow treatment under the final rule "**look through**" the SPE to the bank customer who formed it and that the outflow amount be the same as a credit commitment to the bank customer under the Proposed Rule.

The Denominator: Final Rule's Outflow Amounts for Undrawn Commitments to SPEs

Customer Commitment Type	Outflow Amounts for Undrawn Commitments
Committed credit facilities to SPEs that are consolidated subsidiaries of wholesale customers or counterparties and that do not issue CP or other securities	10%
Committed liquidity facilities to SPEs that are consolidated subsidiaries of wholesale customers or counterparties and that do not issue CP or other securities	30%
Committed credit facilities to SPEs that are consolidated subsidiaries of financial sector entities and that do not issue CP or other securities	40%
Committed liquidity facilities to SPEs that are consolidated subsidiaries of financial sector entities	100%
Committed credit facilities and liquidity facilities to all other SPEs	100%

The Denominator: Determining Outflow Amounts for Undrawn Commitments to SPEs

Step 1:
To what *type of entity* is the commitment extended?

A. Wholesale customer or counterparty

"…*a customer or counterparty that is not a retail customer or counterparty.*"

B. Financial sector entity

- Financial sector entity means "…*an investment advisor, investment company, pension fund, non-regulated fund, <u>regulated financial company</u> or identified company….*"
- Regulated financial company means "…*(1) a depository institution holding company or designated company… (3) a <u>depository institution</u>; foreign bank; credit union; industrial loan company, industrial bank, or similar institution…; national bank, state member bank, or state non-member bank that is not a depository institution….*"

The Denominator: Determining Outflow Amounts for Undrawn Commitments to SPEs (cont'd)

Step 2:
Is SPE a *consolidated subsidiary* of the customer?

Consolidated subsidiary means "*…a company that is consolidated on the balance sheet of a [Bank] or other company under GAAP.*"

Step 3:
Has SPE *issued commercial paper or securities* (other than equity securities issued to a company of which the SPE is a consolidated subsidiary) to finance its purchases or operations?

The Denominator: Structured Transaction Outflow Amount

The Final Rule's structured transaction outflow amount would capture obligations and exposures associated with structured transactions sponsored by a covered company in which the issuing entity **is not consolidated** on the covered company's balance sheet.

The Proposed Rule would have assigned these outflow amounts to sponsored structured transactions regardless of whether the covered company consolidated the issuing entity.

The outflow amount for each of a covered company's sponsored structured transactions would be the greater of:
(a) 100% of the amount of all debt obligations of the issuing entity that mature 30 days or less from the calculation date and all commitments made by the issuing entity to purchase assets within 30 days or less from the calculation date; and
(b) the maximum contractual amount of funding the covered company may be required to provide to the issuing entity 30 days or less from such calculation date through a liquidity facility, a return or repurchase of assets from the issuing entity, or other funding agreement.

Compliance Requirements

U.S. LCR Compliance Timing and Percentages

Compliance Date	1/1/2015	1/1/2016	1/1/2017
Required LCR	80%	90%	100%

Compliance Requirements: Delayed Implementation of Daily Calculation

The Agencies have delayed implementation of the daily calculation in the Final Rule**.**

- Certain covered companies are required to calculate their LCR on the **last business day of the calendar month from January 1, 2015 to June 30, 2015** and must calculate their LCR on **each business day beginning July 1, 2015**:
  - covered companies that are depository institutions holding companies with $700 billion or more in total consolidated assets or $10 trillion or more in assets under custody, and
  - any depository institution that is a consolidated subsidiary of such depository institution holding companies that has consolidated assets equal to $10 billion or more.
- All other covered companies are required to calculate the LCR on the **last business day of the calendar month from January 1, 2015 to June 30, 201**6 and must calculate their LCR **each business day beginning on July 1, 2016**.

Modified LCR Rule

The Federal Reserve Board adopted an LCR requirement tailored for modified LCR companies. Modified LCR companies **are bank holding companies with $50 billion or more of assets that aren't required to use the LCR**.

The Modified LCR Rule is a **simpler** and **less stringent** form of the Final Rule's LCR.

Unique Aspects of Modified LCR:
▪ No "add-on" requirement to total net cash outflows. LCR denominator is based on total net outflows for the relevant calculation period.
▪ 30% haircut for outflows with no contractual maturity date. This includes credit and liquidity commitments to SPEs, which therefore effectively have a 70%, rather than 100%, assumed outflow rate for modified LCR companies.
▪ Monthly calculation of LCR starting on January 1, 2016.
▪ Liquidity coverage ratio of 90% required for 2010 and 100% thereafter.

Application of LCR to Customer Securitization Transactions: Competitive Impact

Hypothetical Transaction Parameters

Bank	Commitment	Drawn Amount	Funding Source
U.S. LCR Bank	$100 million	$50 million	$50 million Balance Sheet
U.S. LCR Bank Using Consolidated ABCP Conduit	$100 million	$50 million	• $25 million ABCP matures in 30 days or less • $25 million in ABCP matures later than 30 days
U.S. Modified LCR Bank	$100 million	$50 million	$50 million Balance Sheet
European Bank Using ABCP Conduit	$100 million	$50 million	• $25 million ABCP matures in 30 days or less • $25 million in ABCP matures later than 30 days

Hypothetical Trade Receivables Transaction With Qualifying Consolidated SPE

(Proposed Rule Outflow Amounts in Parentheses)

Bank	LCR Outflow Amount from Unused Commitment	LCR Outflow from ≤ 30 day ABCP	Total LCR Outflow Amount
U.S. LCR Bank (Balance Sheet Funded)	\$5MM (\$50MM)	0	\$5MM (\$50MM)
U.S. LCR Bank Using Consolidated ABCP Conduit	\$5MM (\$50MM)	\$25MM (\$25MM)	\$30MM (\$75MM)
U.S. Modified LCR Bank	\$3.5MM (\$35MM)	0	\$3.5MM (\$35MM)
European Bank Using ABCP Conduit	\$5MM	\$25MM	\$30MM

Hypothetical Credit Card Transaction With Qualifying Consolidated SPE

(Proposed Rule Outflow Amounts in Parentheses)

Bank	LCR Outflow Amount from Unused Commitment	LCR Outflow from ≤ 30 day ABCP	Total LCR Outflow Amount
U.S. LCR Bank (Balance Sheet Funded)	$20MM ($50MM)	0	$20MM ($50MM)
U.S. LCR Bank Using Consolidated ABCP Conduit	$20MM ($50MM)	$25MM	$45MM ($75MM)
U.S. Modified LCR Bank	$14MM ($35MM)	0	$14MM ($35MM)
European Bank Using ABCP Conduit	$50MM	$25MM	$75MM

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