# Regulatory Briefing Book

## Issue III: Liquidity Coverage Ratio Final Rule

October 16, 2014

SFIG
Structured Finance Industry Group

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October 16, 2014

# Regulatory Briefing – Securitization Perspectives on Final U.S. Liquidity Coverage Ratio Rule

In September 2014, the Office of the Comptroller of the Currency (the "*OCC*"), the Board of Governors of the Federal Reserve System (the "*Board*") and the Federal Deposit Insurance Corporation (the "*FDIC*" and, together with the OCC and the Board, collectively, 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*").[1] The objective of the Final Rule 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. Compliance with the LCR will be tested daily.

## I. Background

During the recent financial crisis, large, internationally active banking organizations were exposed to substantial wholesale market funding risks and contingent liquidity risks. As a result, banking regulators across the globe saw a need to improve short-term resilience in the liquidity profiles of banking organizations.

To that end, the Basel Committee on Banking Supervision ("*BCBS*") published international liquidity coverage ratio standards in December 2010 as part of the Basel III reform package and revised these standards in January 2013 (as revised, the "*Final Basel LCR Guidelines*").[2] In October 2013, the Agencies proposed a rule to implement the LCR requirement in the United States (the "*Proposed Rule*").[3]

As with the Proposed Rule, the Final Rule implements the LCR requirement in a manner mostly consistent with the Final Basel LCR Guidelines - with some modifications that the Agencies believe

1 Liquidity Coverage Ratio: Liquidity Risk Measurement Standards (September 3, 2014) (to be codified at 12 C.F.R. pt. 50, pt. 249, pt. 329) [hereinafter "*Adopting Release*"].

2 *See* BASEL COMMITTEE ON BANKING SUPERVISION, BASEL III: INTERNATIONAL FRAMEWORK FOR LIQUIDITY RISK MEASUREMENT, STANDARDS AND MONITORING (December 2010), http://www.bis.org/publ/bcbs188.pdf; BASEL COMMITTEE ON BANKING SUPERVISION, BASEL III: THE LIQUIDITY COVERAGE RATIO AND LIQUIDITY RISK MONITORING TOOLS (January 2013), http://www.bis.org/publ/bcbs238.pdf.

3 *See* Liquidity Coverage Ratio: Liquidity Risk Measurement, Standards, and Monitoring, 78 Fed. Reg. 230,71818 230,71838 (proposed Nov. 29, 2013) (to be codified at 12 C.F.R. pt. 50, pt. 249, pt. 329). [hereinafter "*Proposed Rule*"].

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reflect the unique characteristics and risks of the U.S. market and U.S. regulatory frameworks.[4] However, the Final Rule is more stringent than the Final Basel LCR Guidelines in several important areas.

On January 31, 2014, the Structured Finance Industry Group ("*SFIG*") and the Securities Industry and Financial Markets Association ("*SIFMA*" and, together with SFIG, collectively, the "*Associations*") submitted a comment letter to the Agencies proposing adjustments to the Proposed Rule.[5] In response to the Associations' comment letter, follow up meetings, and other extensive comments submitted by market participants, the Agencies incorporated a number of changes into the Final Rule. Several of those changes impact the securitization market.

## II. Banking Organizations Subject to the Final Rule

The LCR requirement set forth in the Final Rule applies to organizations that are required to apply the "advanced approaches" risk-based capital rules that were adopted by the Agencies in 2013. More specifically, the Final Rule applies to "**covered companies**," including:

(i) banking organizations with $250 billion or more in total consolidated assets;

(ii) banking organizations with $10 billion or more in total consolidated on-balance sheet foreign exposures;

(iii) consolidated subsidiary depository institutions of these entities with $10 billion or more in total consolidated assets; and

(iv) institutions that an Agency has determined should be subject to the Final Rule in light of its asset size, level of complexity, risk profile, scope of operations, affiliation with foreign or domestic covered entities, or risk to the financial system.[6]

The Final Rule does not apply to:

(i) nonbank financial companies designated by the Financial Stability Oversight Council for supervision by the Board that do not have substantial insurance activities ("**covered nonbank companies"**) and their consolidated subsidiary depository institutions with total assets of $10 billion or more;[7]

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4 *Adopting Release*, *supra* note 1 at 23.

5 Richard Johns & Chris Killian, Structured Finance Industry Group, Securities Industry and Financial Markets Association, Re: Proposed Liquidity Coverage Ratio Requirement, January 31, 2014, http://www.sfindustry.org/images/uploads/pdfs/Proposed%20Liquidity%20Coverage%20Ratio%20Requirements%20Comment%20Letter.pdf [hereinafter "*Comment Letter*"].

6 Section 1(b)(1) of the Final Rule.

7 The Proposed Rule would have applied to covered nonbank companies. *Proposed Rule*, *supra* note 3 at 71819. However, the Adopting Release clarifies that the Final Rule will not apply to covered nonbank companies and

(ii) foreign banking organizations or U.S. intermediate holding companies that are required to be established under **Regulation YY**, other than those companies that are otherwise covered companies;[8]

(iii) a bridge financial company as defined in 12 U.S.C. 5381(a)(3), or a subsidiary of a bridge financial company;[9] or

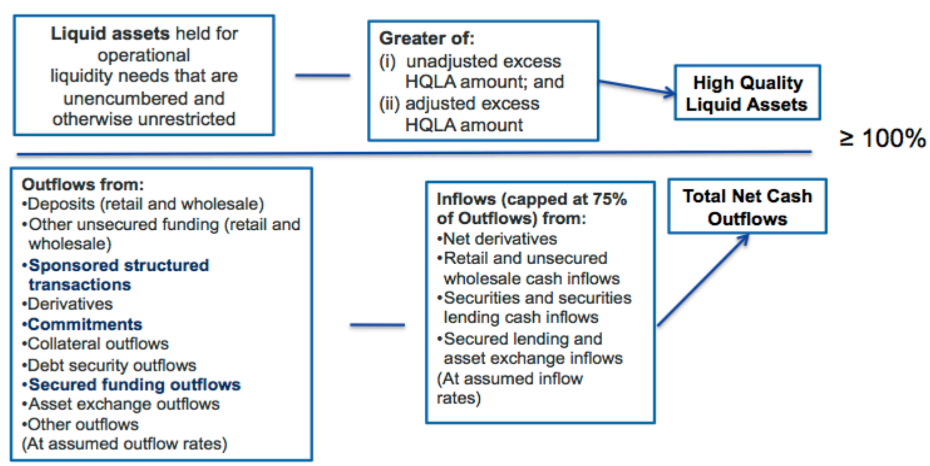
(iv) a new depository institution or a bridge depository institution, as defined in 12 U.S.C. 1813(i).[10]

The Board also adopted a modified version of the LCR requirement that applies to depository institution holding companies that have total consolidated assets of $50 billion or more but are not covered companies ("**modified LCR companies**").[11] For more information about the modified version of the LCR requirement, see section VII below.

### III. An Overview of the Liquidity Coverage Ratio

Consistent with the Final Basel LCR Guidelines and the Proposed Rule, the LCR set forth in the Final Rule is designed to ensure that a covered company has high quality liquid assets (the "*numerator*") sufficient to meet its total net cash outflows over a prospective 30-day period (the "*denominator*").

Computation of LCR:

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indicates that the Board will establish any future LCR requirement for covered nonbank companies by future order or rule. *Adopting Release*, *supra* note 1 at 16.

8 *Adopting Release*, *supra* note 1 at 16.

9 Section 1(b)(3)(i) of the Final Rule.

10 Section 1(b)(3)(ii) of the Final Rule.

11 Section 249.60(a) of Board's Rule.

Once the Final Rule is fully implemented,[12] a covered company will be required to calculate its LCR on each business day (the "*calculation date*") by dividing its HQLA on such calculation date by its total net cash outflows over a period ending 30 calendar days from the calculation date (the "*calculation period"*).

The Final Rule did not establish a reporting requirement for the LCR but, in the Adopting Release, the Agencies indicate that they anticipate issuing a subsequent notice under the Paperwork Reduction Act that will separately seek comment on proposed regulatory reporting requirements and instructions pertaining to a covered company's LCR disclosure.[13]

**IV. The Numerator**

Under the Final Rule, a covered company is permitted to include in its numerator certain liquid assets that it holds for operational liquidity needs that are unencumbered and otherwise unrestricted. Consistent with the Final Basel LCR Guidelines and the Proposed Rule, the Final Rule sets forth criteria and limitations surrounding HQLA that are meant to ensure that a covered company's HQLA amount only includes assets with a high potential to generate liquidity during a stress scenario through either (i) a sale of those assets or (ii) a borrowing secured by those assets.[14] In other words, assets that qualify as HQLA should be easily and immediately convertible into cash with little or no expected loss of value during a period of liquidity stress.

The Final Rule provides for two different levels of liquid assets, referred to as Level 1 liquid assets and Level 2 liquid assets. Level 1 liquid assets are intended to include the highest quality and most liquid assets. Examples of Level 1 liquid assets include Federal Reserve Bank balances and U.S. Treasury securities.[15] A covered company can include the fair value of Level 1 liquid assets in its HQLA amount subject only to a reduction in the amount of the reserve balance requirement under section 204.5 of Regulation D (12 CFR 204.5).[16]

12 *See infra* Section VI for more information about the timing of implementation of the Final Rule.

13 *Adopting Release*, *supra* note 1 at 37.

14 *Id.* at 41.

15 Level 1 liquid assets also include: (i) foreign withdrawable reserves, (ii) liquid and readily-marketable securities issued or unconditionally guaranteed as to the timely payment of principal and interest by a U.S. government agency (provided that its obligations are fully and explicitly guaranteed by the full faith and credit of the U.S. government), (iii) certain liquid and readily-marketable securities that are claims on, or claims guaranteed by, a sovereign entity, a central bank, the Bank for International Settlements, the International Monetary Fund, the European Central Bank and European Community, or a multilateral development bank, and (iv) certain debt securities issued by sovereign entities. *See* Section 20(a) of the Final Rule. Interestingly, the Final Rule does not include cash, whether held in branches or ATMs, in Level 1 liquid assets.

16 Section 21(b) of the Final Rule.



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Level 2 liquid assets are intended to include assets that are relatively stable and have significant sources of liquidity - but not to the same degree as Level 1 liquid assets. Level 2 liquid assets are further divided into two categories: Level 2A liquid assets and Level 2B liquid assets.

Level 2A liquid assets have more price volatility and less liquidity than Level 1 liquid assets. Level 2A liquid assets include: (i) certain GSE securities[17] and (ii) certain obligations issued or guaranteed by a sovereign entity or multilateral development bank.[18] The fair value (as determined under U.S. generally accepted accounting principles ("*GAAP*")) of Level 2A liquid assets is subject to a 15% haircut before being including in a covered company's stock of HQLA.[19]

Level 2B liquid assets have more price volatility and less liquidity than Level 2A liquid assets. Level 2B liquid assets include: (i) certain highly liquid investment grade corporate debt securities[20] and (ii) certain publicly traded shares of common stock. The fair value (as determined under U.S. GAAP) of Level 2B liquid assets is subject to a 50% haircut before being including in a covered company's HQLA stock.[21]

17 Section 20(b)(1) of the Final Rule indicates that Level 2A liquid assets include "a security issued by, or guaranteed as to the timely payment of principal and interest by, a U.S. government-sponsored enterprise, that is investment grade under 12 CFR part 1 as of the calculation date, provided that the claim is senior to preferred stock."

18 Section 20(b)(2) of the Final Rule indicates that Level 2A liquid assets include "a security issued by, or guaranteed as to timely payment of principal and interest by, a sovereign entity or multilateral development bank that is: (i) not included in level 1 liquid assets; (ii) assigned no higher than a 20 percent risk weight under subpart D of [AGENCY CAPITAL REGULATION] as of the calculation date; (iii) issued or guaranteed by an entity whose obligations have a proven record as a reliable source of liquidity in repurchase or sales markets during stressed market conditions, as demonstrated by: (A) the market price of the security or equivalent securities of the issuer declining no more than 10 percent during a 30 calendar-day period of significant stress, or (B) the market haircut demanded by counterparties to secured lending and secured funding transactions that are collateralized by the security or equivalent securities of the issuer increasing by no more than 10 percentage points during a 30 calendar-day period of significant stress; and (iv) not an obligation of a financial sector entity, and not an obligation of a consolidated subsidiary of a financial sector entity."

19 Section 21(b)(ii) of the Final Rule.

20 Under the Proposed Rule, corporate debt securities would have had to be publicly traded on a national securities exchange in order to qualify for inclusion as HQLA. However, the Agencies decided to remove the "publicly traded" requirement for corporate debt securities because corporate debt securities are frequently traded in over-the counter secondary markets and are less frequently listed and regularly traded on national securities exchanges.

21 Section 21(b)(iii) of the Final Rule.

Level 2B liquid assets cannot exceed 15% of a covered company's stock of HQLA and the aggregate amount of a covered company's Level 2A and Level 2B liquid assets cannot exceed 40% of its total stock of HQLA.[22]

*The Numerator: Types of HQLA*

| Type of Liquid Asset | Description | Haircut | Cap |
|---|---|---|---|
| Level 1 | Highest quality and most liquid assets<br>*Example:* U.S. Treasury Securities | N/A | N/A |
| Level 2A | Relative price stability with significant liquidity<br>*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<br>*Examples:* Highly liquid investment grade corporate debt securities and exchange traded corporate equity securities | 50% | Can't exceed 15% of total HQLA |

The only type of structured finance security that qualifies for HQLA treatment under the Final Rule is mortgage-backed securities issued by Fannie Mae and Freddie Mac ("**GSE MBS**") that are (1) investment grade and (2) senior to preferred stock.[23] Under the Final Rule, such GSE MBS are treated as Level 2A liquid assets and, therefore, as described above, are subject to a 15% haircut and, coupled with other Level 2A and Level 2B liquid assets, are subject to a 40% cap of total stock of HQLA. The Final Rule does not afford HQLA treatment to private-label residential mortgage-backed securities ("**RMBS**"),[24] covered bonds[25] or asset-backed securities backed by financial assets other than residential mortgage loans ("**ABS**").[26]

22 Section 21(c) of the Final Rule. For a more detailed description of the numerator calculation including the unadjusted HQLA and the adjusted HQLA, see Section 21(a), (c) and (g) of the Final Rule.

23 For more details regarding the requirements for GSE securities, please see *supra* note 17.

24 In contrast, under the Final Basel LCR Guidelines, RMBS rated AA or better would qualify as Level 2B liquid assets with a 25% haircut.

25 In contrast, under the Final Basel LCR Guidelines, covered bonds rated AA- or better would qualify as Level 2A liquid assets with a 15% haircut.

26 Similarly, the Final Basel LCR Guidelines did not provide HQLA treatment for ABS.



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In the Comment Letter, the Associations argued that certain high quality securitization exposures should qualify for treatment as HQLA because they are sufficiently liquid such that a bank could convert them into cash readily and immediately to meet its outflow obligations. More specifically, the Associations requested that:

- GSE MBS should be afforded Level 1 treatment 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.[27] If the Agencies were unwilling to afford Level 1 treatment, the Associations offered an alternative proposal under which GSE MBS would be excluded from the 40% cap applied to other Level 2A assets.[28]
- Certain high credit quality RMBS[29] should be afforded level 2B liquid asset treatment. RMBS backed exclusively by Qualified Mortgages[30] should qualify subject to a 25% haircut and all other RMBS that securitizes higher credit quality mortgages should qualify subject to a 50% haircut.[31]

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27 *Comment Letter*, *supra* note 5 at 17.

28 *Id.* at 17.

29 Specifically, the Associations proposed that the Agencies provide Level 2B liquid asset treatment to an RMBS that meets the following criteria:

"(1) is a security registered for offer and sale under the Securities Act of 1933 ("Act") or, if exempt from such registration, is eligible for resale in reliance on Rule 144A under the Act;

(2) is a senior security that has a risk-weight of 20 percent or less under the Agencies' standardized approach risk-based capital rules;

(3) the eligible primary underlying exposures consist solely of one-to-four family residential mortgage loans that are not higher-risk consumer loans or non traditional mortgage loans (as such terms are defined in Appendix C to Subpart A of 12 C.F.R. pt. 357);

(4) constitutes a "traditional securitization" under the Agencies' regulatory capital rules; and

(5) is sponsored by an entity whose obligations have a proven track record as a reliable source of liquidity in repurchase or sales markets during stressed market conditions, demonstrated by (A) the market price of the RMBS or equivalent securities of the sponsor declining by no more than 20 percent during a 30 calendar-day period of significant stress, or (B) the market haircut demanded by counterparties to secured lending and secured funding transactions that are collateralized by the RMBS or equivalent securities of the sponsor declining no more than 20 percentage points during a 30 calendar-day period of significant stress."

*See Comment Letter*, *supra* note 5 at 17.



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- Certain high credit quality covered bonds[32] should be afforded Level 2B liquid asset treatment so long as their liquidity characteristics mirror those of publicly traded corporate debt securities.[33]
- Certain high credit quality ABS[34] should be included as Level 2B liquid assets so long as their liquidity characteristics mirror those of publicly traded corporate debt securities.[35]

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30 For these purposes, a "Qualified Mortgage" would be a one-to-four family residential mortgage loan that is not a higher-risk consumer loan or a non traditional mortgage loan (as such terms are defined in Appendix C to Subpart A of 12 C.F.R. pt. 357).

31 *Comment Letter*, *supra* note 5 at 17-18.

32 Specifically, the Associations proposed that the Agencies provide Level 2B liquid asset treatment to a covered bond that meets the following criteria:

"(1) is a security registered for offer and sale under the Act or, if exempt from such registration, is eligible for resale in reliance on Rule 144A of the Act;

(2) is a senior debt security issued by a regulated unaffiliated financial institution located in an OECD country;

(3) is investment grade under the OCC's investment regulation;

(4) the transaction documents with respect to which grant debtholders (or a trustee on their behalf) the right to sell the covered asset pool upon a payment default and such sale count not be stayed or otherwise delayed due to the insolvency of the issuing entity under applicable law; and

(5) is sponsored by an entity whose obligations have a proven track record as a reliable source of liquidity in repurchase or sales markets during stressed market conditions, demonstrated by (A) the market price of the covered bond or equivalent securities of the sponsor declining by no more than 20 percent during a 30 calendar-day period of significant stress, or (B) the market haircut demanded by counterparties to secured lending and secured funding transactions that are collateralized by the covered bond or equivalent securities of the sponsor declining no more than 20 percentage points during a 30 calendar-day period of significant stress."

*Id.* at 20.

33 *Id.* at 20.

34 Specifically, the Associations proposed that the Agencies afford Level 2B liquid asset treatment to ABS that meet the following criteria:

"(1) is a security registered for offer and sale under the Act or, if exempt from such registration, is eligible for resale in reliance on Rule 144A of the Act;



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On October 10, 2014, the European Commission adopted detailed LCR requirements for European credit institutions (the "*EC Requirements*").[36] In contrast to the Final Rule, several categories of structured finance securities are given HQLA status provided that they meet criteria specified in the EC Requirements. More specifically:

(1) Eligible covered bonds issued by European Union credit institutions that are credit quality step 1 under the prudential requirements applicable to credit institutions in the European Union ("*CRD IV*")[37] are treated as level 1 liquid assets subject to a 70% cap and a 7% haircut;

(2) Eligible covered bonds issued by European Union credit institutions that are credit quality step 2 under CRD IV are treated as level 2A liquid assets subject to the 40% cap that applies generally to level 2 liquid assets and a 15% haircut;

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(2) is a senior security that has a risk-weight of 20 percent or less under the Agencies' standardized approach risk-based capital rules;

(3) constitutes a "traditional securitization" exposures under the Agencies' regulatory capital rules;

(4) is backed by an asset pool that was not originated or otherwise owned by the bank or any of its affiliates prior to the relevant securitization transaction; and

(5) is sponsored by an entity whose obligations have a proven track record as a reliable source of liquidity in repurchase or sales markets during stressed market conditions, demonstrated by (A) the market price of the ABS or equivalent securities of the sponsor declining by no more than 20 percent during a 30 calendar-day period of significant stress, or (B) the market haircut demanded by counterparties in secured lending and secured funding transactions that are collateralized by the ABS or equivalent securities of the sponsor declining no more than 20 percentage points during a 30 calendar-day period of significant stress."

*Id.* at 21.

35 *Id.* at 21.

36 Commission Delegated Regulation (EU) No …/.. of 10.10.2014 to supplement Regulation (EU) 575/2013 with regard to liquidity coverage ratio requirement for Credit Institutions, available at: http://ec.europa.eu/internal_market/bank/docs/regcap/acts/delegated/141010_delegated_act_liquidity_coverage_en.pdf.

37 Council Directive 2013/36, On Access to the Activity of Credit Institutions and the Prudential Supervision of Credit Institutions and Investment Firms, 2013 O.J. (L 176), 338-436, available at http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:32013L0036:EN:NOT.



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(3) Eligible covered bonds issued by credit institutions outside the European Union that are credit quality step 1 under CRD IV are treated as level 2A liquid assets subject to the 40% cap that applies generally to level 2 liquid assets and a 15% haircut;

(4) Eligible covered bonds issued by European Union credit institutions that are unrated are treated as level 2B liquid assets subject to the 15% cap that applies generally to level 2B liquid assets and the 40% cap that applies generally to level 2 liquid assets and a 30% haircut;

(5) Eligible asset-backed securities backed by qualifying residential mortgages and auto loans and leases are treated as level 2B liquid assets subject to the 15% cap that applies generally to level 2B liquid assets and the 40% cap that applies generally to level 2 liquid assets and a 25% haircut; and

(6) Eligible asset-backed securities backed by qualifying loans to small and medium-sized enterprises and consumer loans (including credit card receivables) are treated as level 2B liquid assets subject to the 15% cap that applies generally to level 2B liquid assets and the 40% cap that applies generally to level 2 liquid assets and a 35% haircut.

## V. The Denominator

For purposes of the denominator, a covered company's total net cash outflow amount is determined by taking amounts the covered company is expected to pay out during a calculation period ("*outflows*") and subtracting amounts the covered company is expected to receive during the same calculation period ("*inflows*").

The Final Rule sets forth the methodology used to determine a covered company's outflows and inflows. In the Adopting Release, the Agencies indicate that the measurements of outflow and inflow rates set forth in the Final Rule are meant to take into account the impact of historical stress events, including the recent financial crisis.[38]

Also, under the Final Rule inflows that a covered company uses to offset outflows are capped at 75% of outflows[39] to ensure that "covered companies are maintaining sufficient on-balance sheet liquidity and are not overly reliant on inflows, which may not materialize in a period of stress."[40]

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38 More specifically, the Agencies indicate that the net outflow components of the Final Rule are intended to take into account the "potential impact of idiosyncratic and market-wide shocks, including those that would result in: … (2) a partial loss of secured, short-term financing with certain collateral and counterparties; …(4) unscheduled draws on committed credit and liquidity facilities that a covered company has provided to its customers; (5) the potential need for a covered company to buy back debt or to honor non-contractual obligations in order to mitigate reputation and other risks; …and (7) other shocks that affect outflows linked to structured finance transactions, mortgages, central bank borrowings, and customer short positions." *Adopting Release*, *supra* note 1 at 19-20.

39 Section 30(a)(2)(ii) of the Final Rule.



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### A. Calculation of Net Outflows

The Proposed Rule would have required covered companies to calculate net outflows using a "peak day" approach. Under the peak day approach, covered companies would have been required to hold HQLA against their **largest cumulative cash outflow day** within a 30-day calculation period.[41] 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 day that they could occur during the 30-day calculation period.[42]

The Final Rule replaces the "peak day" approach set forth in the Proposed Rule with an "add-on" approach that involves three steps.

1. First, the covered company must determine: a) the net cumulative maturity outflow amount for each day during the calculation period by aggregating and netting certain specified outflows and inflows that have set maturity dates within the calculation period; and b) then identify the single day with the largest net cumulative maturity outflow amount during such calculation period ("largest single day net cumulative maturity outflow").[43]
2. Second, the covered company must determine the net day 30 cumulative maturity outflow amount as of the 30th day of the relevant calculation period by aggregating and netting the same specified types of outflows and inflows that have a maturity date within 30 days of the calculation date.[44]
3. Third, the covered company must calculate the difference between the largest single day net cumulative maturity outflow a mount and the net day 30 cumulative maturity outflow amount on the last day of the calculation period.[45]

The add-on is the greater of the amount determined in Step 3 and zero.[46]

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40 *Adopting Release*, *supra* note 1 at 20.

41 *Proposed Rule*, *supra* note 3 at 71819.

42 *Id.* at 71819.

43 Specifically, Section 30(b)(1)(i) of the Final Rule defines the net cumulative maturity outflow amount for each calendar day during the calculation period as: (x) the sum of the outflow amounts for instruments or transactions identified under Sections 32(g), (h)(1), (h)(2), (h)(5), (j), (k) and (l) that have a maturity date on or prior to that date minus (y) the sum of the inflow amounts for instruments or transactions identified in Sections 33(c), (d), (e) and (f) that have a maturity date on or prior to that date. *See* Section 30(b)(1)(i) of the Final Rule.

44 Section 30(b)(1)(ii) of the Final Rule.

45 Section 30(b)(2) of the Final Rule.



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The add-on approach set forth in the Final Rule is more conservative than the calculation of net outflows set forth under the Final Basel LCR Guidelines (which calculates net outflows based on the net cumulative maturity outflow amount without a maturity mismatch add-on) but substantially less conservative than the "peak day" calculation set forth under the Proposed Rule.

**B. 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[47] 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.[48]

As described below, the Final Rule provides specific guidance regarding determining outflow amounts in circumstances involving (1) options and (2) notice periods.

**1. Options**

Section 32(a)(1) of the Final Rule sets forth several assumptions that a covered company is required to make in determining the earliest possible contractual maturity date or the earliest possible date the transaction could occur:

(a) If an investor or funds provider has an option that would reduce the maturity, the covered company must assume that the investor or funds provider will exercise the option at the earliest possible date;[49]

(b) If an investor or funds provider has an option to extend a maturity, the covered company must assume that the investor or funds provider will not exercise the option;[50]

(c) Subject to the longer-term callable bond exception described below, if the covered company has the option to reduce a maturity, the covered company must assume that it will exercise the option at the earliest possible date;[51] and

46 Section 30(b)(2)(i)(A) and Section 30(b)(2)(ii)(A) of the Final Rule.

47 Section 31(a)(1) of the Final Rule.

48 Section 31(a)(2) of the Final Rule.

49 Section 31(a)(1)(i) of the Final Rule.

50 Section 31(a)(1)(ii) of the Final Rule.

(d) If the covered company has the option to extend the maturity of the obligation it issued, the covered company must assume that it will not exercise that option to extend the maturity.[52]

In the Adopting Release, the Agencies indicate that they understand that their requirements for determining maturity may not comport with the stated requirements for call options in some legal agreements. However, they believe that the conservative assumptions in the Final Rule ensure a more accurate assessment of a covered company's liquidity resiliency through the LCR.[53]

The Final Rule makes an exception for longer-term callable bonds and treats the original maturity date of the instrument as the "maturity of the obligation" for purposes of the LCR. Specifically, under Section 31(a)(1)(iii)(A) of the Final Rule, when a bond issued by a covered company has an original maturity greater than one year and the call option held by the covered company does not go into effect for a period of 180 days following the issuance, the original maturity date of the bond will be the "maturity" of the obligation for purposes of the LCR. In the Adopting Release, the Agencies explain that they have concluded that covered companies would not likely be susceptible during a period of liquidity stress to significant market pressure to exercise these call options.[54]

The Final Rule also makes an exception for transactions in which the covered company's counterparty is a sovereign entity, a U.S. government-sponsored enterprise, or a public sector entity and treats the original maturity date of the obligation as the "maturity of the obligation" for purposes of the LCR.[55] In the Adopting Release, the Agencies explain that they believe that there is less reputational pressure on banks to exercise options in transactions with these types of counterparties.[56]

**2. Notice Periods**

Section 31(a)(1)(v) of the Final Rule provides that, if an option is subject to a "contractually defined notice period," the covered company "must determine the earliest possible contractual maturity date regardless of the notice period." In the Adopting Release, the Agencies note that "notice periods for draws on commitments are not recognized."[57]

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51 Section 31(a)(1)(iii) of the Final Rule.

52 Section 31(a)(1)(iv) of the Final Rule.

53 *Adopting Release*, *supra* note 1 at 154.

54 *Adopting Release*, *supra* note 1 at 151.

55 Section 31(a)(1)(iii)(B) of the Final Rule.

56 *Adopting Release*, *supra* note 1 at 151.

57 *Id.* at 181.



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In the Adopting Release, the Agencies indicate their belief that reputational considerations may drive a covered company's behavior with respect to notice periods and indicate that they believe that these reputational considerations exist for all types of counterparties and regardless of whether there are contractual provisions favoring the covered company.[58] The Agencies also note that, during the financial crisis, many options were exercised in a manner that was disadvantageous to the banking organization or financial institution to protect its market reputation.[59]

**C. Outflow Amounts**

The Final Rule sets forth outflow categories used to determine cash outflows and assigns an outflow rate for each outflow category ranging from 0% to 100%. The outflow categories of particular relevance to the securitization market are: (1) the commitment outflow amount; (2) the structured transaction outflow amount; and (3) the secured funding outflow amount.

The Final Rule excludes amounts arising from certain intragroup transactions from a covered company's outflow amount. Specifically, Section 32(m) of the Final Rule expressly excludes amounts arising out of transactions between (i) the covered company and a consolidated subsidiary of the covered company and (ii) a consolidated subsidiary of the covered company and another consolidated subsidiary of the covered company. For these purposes, a "consolidated subsidiary" includes any entity that is consolidated onto the balance sheet of the covered company for purposes of GAAP.[60]

As a result, if the issuing entity in a securitization transaction is consolidated with a covered company, then the transactions between that covered company and the issuing entity are excluded as intragroup transactions under Section 32(m). However, any outflows and inflows of the issuing entity would be included in the covered company's outflows and inflows because the issuing entity is a consolidated subsidiary of the covered company.

**1. Commitment Outflow Amount**

The "commitment outflow amount" set forth in Section 32(e) of the Final Rule captures the undrawn portion of committed credit and liquidity facilities provided by a covered company to its customers and counterparties that could be drawn within the calculation period.[61] With respect to committed liquidity

58 *Id.* at 154.

59 *Id.* at 154.

60 The Final Rule defines "consolidated subsidiary" to mean, "a company that is consolidated on the balance sheet of a [BANK] or other company under GAAP."

61 Pursuant to Section 32(e)(2) and (3) of the Final Rule, the undrawn amount of a committed credit or liquidity facility may be reduced by (x) the fair value of Level 1 liquid assets and (y) 85% of the fair value of Level 2A liquid assets pledged by the covered company to secure the facility; <u>provided</u> that (i) the assets pledged upon a draw on the facility would be eligible HQLA and (ii) the covered company has not included the assets as eligible HQLA in determining its LCR numerator as of the relevant calculation date.



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facilities, the Adopting Release indicates that the amount that "could be drawn" under such facilities would not include a commitment that supports obligations with maturities of greater than 30 days if the commitment's contractual terms "are so limiting."[62]

**(a) Proposed Rule**

Under the Proposed Rule, the outflow amount assigned to a particular facility was a function of (1) the type of customer to whom the customer was extended and (2) whether the facility was a credit facility or a liquidity facility. In general, under the Proposed Rule, the Agencies proposed to treat facilities extended by a covered company to a non-financial corporate customer more favorably than facilities extended to a bank or a non-bank financial institution. Also, the Agencies proposed to treat credit facilities more favorably than liquidity facilities.

However, under the Proposed Rule, the undrawn portion of a credit or liquidity facility extended by the covered company to any special purpose entity that could be drawn upon within 30 days of the calculation date would have been assigned a 100% outflow amount.[63] In the Proposing Release, the Agencies indicated that they proposed the 100% outflow amount rate for special purpose entities "…given SPEs' sensitivity to emergency cash and backstop needs in a short-term stress environment, such as those experienced with SPEs during the recent financial crisis."[64] The Agencies continued on to indicate that "[d]uring that period, many SPEs experienced severe cash shortfalls, and they could not rollover debt and had to rely on borrowing and backstop lines."[65]

In the Comment Letter, the Associations noted that the Agencies' proposal to treat all SPEs uniformly ignored fundamental differences between distinct types of transactions.[66] While the Associations agreed that certain SPEs that were established to issue short-term indebtedness, such as structured investment vehicles, did cause liquidity demands at banks during the recent financial crisis, this was by no means the case with respect to all SPEs established in connection with securitization transactions.[67]

The Associations explained that transactions in which an SPE acts as a borrower under a securitization credit facility to finance the receivables owned by a corporate entity (which the Associations referred to

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62 *Adopting Release*, *supra* note 1 at 181.

63 *Proposed Rule*, *supra* note 3 at 71837.

64 *Id.* at 71838.

65 *Id.*

66 *Comment Letter*, *supra* note 5 at 4.

67 *Id.* at 3-4.



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as a "**bank customer securitization credit facility**")[68] are established as substitutes for, or complements to, traditional secured and unsecured revolving credit facilities and proposed that the outflow amount for a bank customer securitization credit facility should match the outflow amount that would apply to a credit facility extended directly to the bank customer.[69] In other words, for these transactions, the

68 The Associations proposed to define a "bank customer securitization credit facility" as "a traditional securitization (as defined in the Agencies' risk-based capital rules):

(a) that is sponsored by a customer of one or more banks;

(b) through which the customer obtains financing either (i) directly from one or more such banks, or (ii) through one or more asset-backed commercial paper conduits that are supported with liquidity facilities from one or more such banks with commitment amounts (together with commitment amounts from other financial institutions, government agencies and government-sponsored entities) that at least cover the fact amount of the asset-backed commercial paper used to fund such financing;

(c) where the customer is not one of such banks, or an affiliate of one of such banks, extending such financing or providing a liquidity or credit facility to an asset-backed commercial paper conduit that is extending such financing;

(d) where one or more banks or asset-backed commercial paper conduits, or an agent on its or their behalf, negotiates and agrees to the terms of the financing directly with the customer or the special purpose entity sponsored by the customer;

(e) where the eligible primary underlying exposures have been originated or acquired by the customer to further a long-term business objective and proceeds of borrowings by the customer or the special purpose entity sponsored by the customer under the facility are used to finance such exposures;

(f) where, for at least 95 percent of the eligible primary underlying exposures, the obligor is not a depository institution, depository institution holding company, foreign bank or consolidate subsidiary of any of the foregoing;

(g) where the terms of the underlying transaction are not subject to triggers that require eligible primary underlying exposures to be sold if the market value of such exposures declines below a specified level;

(h) that contains terms requiring compliance with any applicable laws and regulations governing credit risk retention by sponsors of traditional securitizations; and

(i) where, after initial financing is extended, none of such banks or asset-backed commercial paper conduits are required to fund any commitment to such customer or its special purpose entity unless eligible primary underlying exposures exist and are available to secure such additional funding as required by the contractual terms of the financing."

*Id.* at 5-6.

69 *Id.* at 5-6.

Associations proposed that the outflow treatment under the final rule "look through" the special purpose entity to the bank customer who formed it and that the outflow amount be the same as a credit commitment to the bank customer.[70] For example, under the Association's proposed approach, a committed credit facility extended to a special purpose entity formed by a non-financial corporate customer would receive the same 10% outflow amount assigned to a revolving credit facility extended directly to the non-financial corporate customer.

The Proposed Rule's outflow amounts for undrawn credit and liquidity commitments relevant to securitization transactions were as follows:

**Proposed Rule's**
**Outflow Amounts for Undrawn Commitments**[71]

| Customer & Commitment Type | Outflow Amounts for Undrawn Commitments |
|---|---|
| Committed credit facilities to wholesale customers and counterparties | 10% |
| Committed liquidity facilities to wholesale customers and counterparties | 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 regulated non-bank financial institutions | 40% |
| Committed liquidity facilities to regulated non-bank financial institutions | 100% |
| Committed credit and liquidity facilities to special purpose entities | 100% |

**(b) Final Rule**

Recognizing that not all SPEs are exposed to the highest degree of liquidity risk, the Agencies decided to limit application of the 100% outflow rate under the Final Rule only to SPEs they see as being highly susceptible to stressed market conditions.[72] However, the Agencies did not address this issue in the

70 *Id.* at 4.

71 *Proposed Rule*, *supra* note 3 at 71838.

72 *Adopting Release*, *supra* note 1 at 181.



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manner proposed by the Associations. Rather than adopting the definition of "bank customer securitization credit facility" proposed by the Associations, the Agencies instead limited the application of the 100% outflow rate to the undrawn portions of committed credit and liquidity facilities extended to SPEs that issue or have issued securities or commercial paper to finance their purchases or operations.[73]

Consistent with the Proposed Rule, the outflow amount assigned to the undrawn portion of a committed credit or liquidity facility under the Final Rule is a function of (1) the type of customer or counterparty to whom the facility is extended, and (2) whether the facility is a credit facility or a liquidity facility. The Final Rule's outflow amounts for undrawn credit and liquidity commitments relevant to securitization transactions are as follows:

**Final Rule's**
**Outflow Amounts for Undrawn Commitments to SPEs**[74]

| Customer & Commitment Type | Outflow Amounts for Undrawn Commitments |
|---|---|
| Committed credit facilities to:<br>▪ Wholesale customers and counterparties<br>▪ SPEs that are consolidated subsidiaries of wholesale customers and counterparties that do not issue commercial paper or securities | 10% |
| Committed liquidity facilities to:<br>▪ Wholesale customers and counterparties<br>▪ SPEs that are consolidated subsidiaries of wholesale customers and counterparties that do not issue commercial paper or securities | 30% |
| Committed credit facilities to:<br>▪ Financial sector entities (excluding depository institutions, depository institution holding companies and foreign banks)<br>▪ SPEs that are consolidated subsidiaries of <u>financial sector entities</u>[75] that do not issue commercial paper or securities | 40% |
| Committed liquidity facilities to:<br>▪ Financial sector entities<br>▪ SPEs that are consolidated subsidiaries of financial sector entities | 100% |
| Committed credit and liquidity facilities to all other SPEs | 100% |

73 *Id.* at 181. The Final Rule also applies a 100% outflow rate to undrawn committed liquidity facilities extended to financial sector entities and their consolidated subsidiaries, including SPEs. Section 32(e)(vii) of the Final Rule.

74 Section 32(e)(1) of the Final Rule.

75 Because the definition of "financial sector entity" includes a depository institution or bank, undrawn credit commitments extended to qualifying consolidated subsidiaries of depository institutions or banks are assigned a 40% outflow rate. Section 32(e)(vi) of the Final Rule.



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To determine the outflow amount for an undrawn commitment to a special purpose entity under the Final Rule, a covered company must answer four questions.

**(i) Is the facility a "committed" credit or liquidity facility?**

- Under the Final Rule, a credit or liquidity facility is "**committed**" if the legally binding, written terms governing the facility either (a) prohibit the covered company from refusing to extend credit or funding under the facility or (b) permit the covered company to refuse to extend credit under the facility only upon the satisfaction or occurrence of one or more specified conditions (not including change in financial condition of the borrower, customary notice, or administrative conditions).[76]
- The Final Rules defines a "**liquidity facility**" as "a legally binding written 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."[77] In the Proposing Release, the Agencies had proposed to require that a liquidity facility be made "expressly" for the purpose of refinancing debt. However, the Agencies eliminated this requirement in the Final Rule and, in the Adopting Release, indicate that the Final Rule is intended to include commitments that are being used to refinance debt, "regardless of whether there is an express contractual clause."[78]

76 The Final Rule defines "committed" to mean, "with respect to a credit facility or liquidity facility, that under the terms of the legally binding written agreement governing the facility: (1) The [BANK] may not refuse to extend credit or funding under the facility; or (2) the [BANK] may refuse to extend credit under the facility (to the extent permitted under applicable law) only upon the satisfaction or occurrence of one or more specified conditions not including change in financial condition of the borrower, customary notice, or administrative conditions." Section 3 of the Final Rule.

77 The Final Rule defines "liquidity facility" to mean, "a legally binding written 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. A liquidity facility includes an agreement to provide liquidity support to asset-backed commercial paper by lending to, or purchasing assets from, any structure, program or conduit in the event that funds are required to repay maturing assets-backed commercial paper. Liquidity facilities exclude facilities that are established solely for the purpose of general working capital, such as revolving credit facilities for general corporate or working capital purposes. If a facility has characteristics of both credit and liquidity facilities, the facility must be classified as a liquidity facility." Section 3 of the Final Rule.

78 *Adopting Release*, *supra* note 1 at 179.



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- A "**credit facility"** is any other legally binding agreement to extend funds if requested at a future date.[79]
- A facility that has characteristics of both a credit facility and a liquidity facility constitutes a liquidity facility for purposes of the LCR.[80]

**(ii) To what type of entity is the commitment extended?**

- Wholesale customer or counterparty

  A "**wholesale customer or counterparty**" is "…a customer or counterparty that is not a retail customer or counterparty."[81]

- Financial sector entity

  "**Financial sector entity**" means "…an investment advisor, investment company, pension fund, non-regulated fund, regulated financial company or identified company…."[82]

  "**Regulated financial company**" means "…(1) a depository institution holding company or designated company… (3) a depository institution; 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…."[83]

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79 The Final Rule defines "credit facility" to mean, "a legally binding agreement to extend funds if requested at a future date, including a general working capital facility such as a revolving credit facility for general corporate or working capital purposes. A credit facility does not include a legally binding written 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." Section 3 of the Final Rule.

80 *See supra* note 75 for definition of "liquidity facility."

81 The Final Rule defines "wholesale customer or counterparty" to mean, "a customer or counterparty that is not a retail customer or counterparty." Section 3 of Final Rule. The Final Rule defines "retail customer or counterparty" to mean, "a customer or counterparty that is: (1) an individual; (2) a business customer, but solely if and to the extent that: (i) the [BANK] manages its transactions with the business customer, including deposits, unsecured funding, and credit facility and liquidity facility transactions, in the same way it manages its transactions with individuals; (ii) transactions with the business customer have liquidity risk characteristics that are similar comparable transactions with individuals; and (iii) the total aggregate funding raised from the business customer is less than $1.5 million; or (3) a living or testamentary trust that: (i) is solely for the benefit of natural persons; (ii) does not have a corporate trustee; and (iii) terminates 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, if applicable under state law." Section 3 of the Final Rule.

82 The Final Rule defines "financial sector entity" to mean, "an investment advisor, investment company, pension fund, non-regulated fund, regulated financial company, or identified company." Section 3 of the Final Rule.

83 The Final Rule defines "regulated financial company" to mean: "(1) A depository institution holding company or designated company; (2) a company included in the organization chart of a depository institution holding company on the Form FR Y-6, as listed in the hierarchy report of the depository institution holding company produced by the National Information Center (NIC) Web site, provided that the top-tier depository institution



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Interestingly, a specific look-through was not provided for SPEs that are consolidated subsidiaries of banks at the 50% level. However, because banks are "financial sector entities," a 40% outflow amount would apply to the undrawn portion of a committed credit facility extended to a qualifying subsidiary that is a consolidated subsidiary of a bank.

**(iii) Is the special purpose entity a consolidated subsidiary of the customer?**

- "**Consolidated subsidiary**" means a company that is consolidated on the balance sheet of the covered company under GAAP.[84]

**(iv) Has the special purpose entity issued commercial paper or securities (other than equity securities issued to the company of which the special purpose entity is a consolidated subsidiary) to finance its purchases or operations?**

In the Adopting Release, the Agencies indicate that the outflow rates for committed credit and liquidity facilities to SPEs set forth in the Proposed Rule were revised in the Final Rule so that "only SPEs that rely on the market for funding receive the 100% outflow rate."[85] The Agencies go on to say that "[t]his change should address commenters' concerns about inappropriate outflow rates for SPEs that are wholly funded by long-term bank loans and similar facilities and do not have the same liquidity risk characteristics as those that rely on the market for funding."[86]

holding company is subject to a minimum liquidity standard under 12 CFR 249; (3) a depository institution; foreign bank; credit union; industrial loan company, industrial bank, or other similar institution described in section 2 of the Bank Holding Company Act of 1956, as amended (12 U.S.C. 1841 et seq.); national bank, state member bank, or state non-member bank that is not a depository institution; (4) an insurance company; (5) a securities holding company as defined in section 618 of the Dodd-Frank Act (12 U.S.C. 1850a); broker or dealer registered with the SEC under section 15 of the Securities Exchange Act (15 U.S.C. 78o); futures commission merchant as defined in section 1a of the Commodity Exchange Act (7 U.S.C. 1a); or security-based swap dealer as defined in section 3 of the Securities Exchange Act (15 U.S.C. 78c); (6) a designated financial market utility, as defined in section 803 of the Dodd-Frank Act (12 U.S.C. 5462); and (7) any company not domiciled in the United States (or a political subdivision thereof) that is supervised and regulated in a manner similar to entities described in paragraphs (1) through (6) of this definition (e.g., a foreign banking organization, foreign insurance company, foreign securities broker or dealer foreign financial market utility); (8) a regulated financial company does not include: (i) U.S. government-sponsored enterprises; (ii) small business investment companies, as defined in section 102 of the Small Business Investment Act of 1958 (15 U.S.C. 661 et seq.); (iii) entities designated as Community Development Financial Institutions (CDFIs) under 12 U.S.C. 4701 et seq. and 12 CFT part 1805; or (iv) central banks, the Bank for International Settlements, the International Monetary Fund, or multilateral development banks." Section 3 of the Final Rule.

84 *See supra* note 58 for definition of "consolidated subsidiary."

85 *Adopting Release*, *supra* note 1 at 20.

86 *Id.* at 20.



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The Final Rule does not define the term "security." In the Adopting Release, the Agencies indicate that they believe that SPEs that issue or have issued securities or commercial paper are "highly susceptible to stressed market conditions during which they may be unable to refinance their maturing securities or commercial paper."[87] While not entirely clear, this would seem to indicate that the term "security" for these purposes would mean an obligation that is sold in a market and would not include a privately negotiated debt obligation.

The Final Rule's requirement that the SPE has not issued securities or commercial paper might be problematic in any structure where separate undrawn credit or liquidity facilities are extended to a single SPE "that also issues or has issued commercial paper or securities."[88]

**2. Structured Transaction Outflow Amount**

The "structured transaction outflow amount" set forth in Section 32(b) of the Final Rule captures obligations and exposures associated with structured transactions[89] sponsored by a covered company in which the issuing entity <u>is not consolidated</u> on the covered company's balance sheet.[90] Under the Final Rule, 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.[91]

The Proposed Rule would have assigned these outflow amounts to structured transactions sponsored by the covered company without regard to whether the covered company consolidated the issuing entity onto its balance sheet or whether any credit or liquidity support was being provided by the covered company to the issuing entity.[92] In the Comment Letter, the Associations argued that a sponsored

87 *Id.* at 180.

88 For example, an unfunded credit or liquidity commitment to a revolving master trust used in credit card or dealer floorplan transaction may be subject to a 100% outflow amount in cases where the revolving master trust has issued publicly registered ABS.

89 The Final Rule defines "structured transaction" to mean, "a secured transaction in which repayment of obligations and other exposures to the transaction is largely derived, directly or indirectly, from the cash flow generated by the pool of assets that secures the obligation and other exposures to the transaction." Section 3 of the Final Rule.

90 Section 32(b) of the Final Rule.

91 Section 32(b) of the Final Rule.

92 *Proposed Rule*, *supra* at 71837.



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structured transaction pursuant to which the covered company securitizes its own assets that meets the definition of "traditional securitizations" in the Agencies' regulatory capital rules[93] should not be an outflow amount under Section 32(b) so long as the covered company does not extend credit or liquidity support to the transaction.[94]

In the Adopting Release, the Agencies note that the structured transaction outflow amount includes outflows beyond contractual commitments because a sponsor may provide support despite the absence of such a commitment.[95] However, the Final Rule does not provide a definition of "sponsor."

Instead, in the Adopting Release, the Agencies indicate that they believe that the term "sponsor" is generally understood within the marketplace.[96] They intend Section 32(b) to apply to all covered companies that would have explicit or implicit obligations to support a structured transaction of an issuing entity that is not consolidated by the covered company during a period of liquidity stress.[97] Generally, the Agencies consider covered companies to be sponsors when "…they have significant control or influence over the structuring, organization or operation of a structured transaction."[98]

### 3. Other Outflow Amounts That May Apply to Sponsored Securitization Vehicles That ARE Consolidated with the Covered Company

The obligations and exposures associated with a structured transaction sponsored by a covered company in which the issuing entity is consolidated on the covered company's balance sheet are determined under either the "secured funding transaction" outflow amount in Section 32(j) of the Final Rule or the "other contractual outflow amounts" set forth in Section 32(l) of the Final Rule.

### (a) Secured Funding Transactions

Under Section 32(j) of the Final Rule, outflow rates for secured funding transactions that "mature" during a calculation period are based on the HQLA categorization of the assets securing the transaction.[99]

The Final Rule defines a "secured funding transaction" as "any funding transaction that is subject to a legally binding agreement as of the calculation date and gives rise to a cash obligation of the [BANK] that is secured under applicable law by a lien on specifically designated assets owned by the [BANK] that

93 For the Agencies' definition of "traditional securitization," *see* 12 C.F.R. Pt. 324, 55484 (September 10, 2013).

94 *Comment Letter*, *supra* note 5 at 12.

95 *Adopting Release*, *supra* note 1 at 164.

96 *Id.* at 165.

97 *Id.*

98 *Id.*

99 Section 32(j) of the Final Rule.



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gives the counterparty, as holder of the lien, priority over the assets in the event the [BANK] enters into receivership, bankruptcy, insolvency, liquidation, resolution or similar proceeding. Secured funding transactions include repurchase transactions, loans of collateral to the [BANK]'s customers to effect short positions, other secured loans, and borrowings from a Federal Reserve Bank."[100]

Secured funding transactions maturing within 30 calendar days of the calculation date give rise to cash outflows during the calculation period. Thus, under the Final Rule, secured funding outflow rates progressively increase depending upon whether the secured funding transaction is secured by Level 1 liquid assets, Level 2A liquid assets, Level 2B liquid assets or by assets that are not HQLA. These outflow rates are 0%,[101] 15%,[102] 50%,[103] and 100%,[104] respectively.

In the Adopting Release, the Agencies indicate that, as a general matter, "the outflow rate for a secured funding transaction should not be greater than that applicable to an equivalent wholesale unsecured funding transactions (that is not an operational deposit) from the same counterparty."[105] Therefore, under Section 32(j)(2), the Final Rule permits the covered company to apply the lower outflow rate applicable to an unsecured wholesale funding transaction where the outflow rate applicable to a secured funding transaction (conducted with a counterparty that is not a retail customer or counterparty) would exceed that of an equivalent unsecured wholesale funding transaction (that is not an operational deposit).

**(b) Other Contractual Outflow Amounts**

To the extent that amounts payable under a securitization transaction are not "secured funding transaction" outflow amounts covered under Section 32(j), Section 32(l) of the Final Rule sets forth a catch-all category called "other contractual outflow amounts" that captures a funding or amounts that are payable by the covered company to counterparties under legally binding agreements that are not otherwise specified in another subsection of Section 32.[106] The Final Rule specifically excludes operating expenses of the covered company (such as rent, salaries, utilities and other similar payments).[107] However, it would capture outflow amounts related to sponsored securitization transactions that are consolidated onto the covered company's balance sheet (and, therefore, not captured under Section

100 Section 3 of Final Rule.

101 Section 32(j)(1)(i) of the Final Rule.

102 Section 32(j)(1)(ii) of the Final Rule.

103 Section 32(j)(1)(iii) of the Final Rule.

104 Section 32(j)(1)(iv) of the Final Rule.

105 *Adopting Release*, *supra* note 1 at 245.

106 Section 32(l) of the Final Rule.

107 Section 32(l) of the Final Rule.



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32(b)) and that do not otherwise constitute secured funding transaction outflow amounts as described above.

**4. Application of Final Rule Outflow Amounts to Specific Securitization Structures**

**(a) Outflow Amounts for ABCP Conduit Exposures**

The outflow amounts associated with ABCP conduit exposures depend on whether the ABCP conduit is (i) sponsored by a covered company and consolidated with the covered company sponsor, (ii) sponsored by a covered company but not consolidated with the covered company, or (iii) not sponsored by a covered company.

**(i) Consolidated ABCP Conduits**

As discussed in Section V.C.2. above, the outflow amounts for sponsored structured transactions under Section 32(b) of the Final Rule do not apply to sponsored structured finance transactions where the issuing entity is consolidated with a bank for accounting purposes. In addition, Section 32(m) of the Final Rule provides that outflow amounts do not include amounts arising out of transactions between a bank and a "consolidated subsidiary." This means that credit and liquidity facilities provided by a covered company to an asset-backed commercial paper ("*ABCP*") conduit that is consolidated with the covered company would not attract outflow amounts under the Final Rule.

However, because compliance with the LCR is determined on a consolidated basis, a covered company which consolidates an ABCP conduit (1) is deemed to issue any ABCP of the conduit (which means that all ABCP with maturities within the calculation period attracts a 100% outflow amount); and, (2) has an undrawn credit commitment to the customer SPE equal to the difference between the total commitment and all outstanding ABCP (which credit commitment attracts an outflow amount in accordance with the applicable subsection of Section 32(e) of the Final Rule).

**(ii) Sponsored But Unconsolidated ABCP Conduits**

Sponsored but unconsolidated ABCP conduits would be assigned outflow amounts as "sponsored structured transactions" under Section 32(b) of the Final Rule. This means that a covered company's outflow amounts for such ABCP conduits will be equal to the greater of (a) 100% of the amount of all ABCP that matures within 30 days following the calculation date and all commitments made by the ABCP conduit to purchase assets within 30 days following the calculation date; and (b) the maximum contractual amount of funding the sponsoring covered company may be required to provide to the ABCP conduit within 30 day following such calculation date through a liquidity facility. As currently structured, the portion of many liquidity facilities that support ABCP with maturities of greater than 30 days could be drawn earlier than the relevant maturity dates under the contractual terms of such facilities, meaning that the outflow amount for such liquidity facilities could be the entire undrawn amount of the relevant bank's commitment under such facilities.



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### (iii) ABCP Conduits Not Sponsored by a Covered Company

Structured finance outflow amounts under Section 32(b) of the Final Rule do not apply to third party-sponsored conduits. Instead, any outflow amounts with respect to undrawn commitments under credit and liquidity facilities provided to ABCP conduits would be assigned outflow amounts under Section 32(e) of the Final Rule. These undrawn commitments would be assigned a 100% outflow amount under Section 32(e)(1)(viii) of the Final Rule since they constitute undrawn amounts under credit or liquidity facilities extended to SPEs that issue commercial paper. As currently structured, the portion of many liquidity facilities that support ABCP with maturities of greater than 30 days could be drawn earlier than the relevant maturity dates under the contractual terms of such facilities, meaning that the outflow amounts for such liquidity facilities could be the entire undrawn amount of the relevant bank's commitment under such facilities.

### b. Outflow Amounts for Sponsored Securitization Transactions (Other than ABCP Conduit Facilities)

Outflow amounts associated with securitization transactions sponsored by a covered company that are not ABCP conduit facilities depend on whether the issuing entity is a consolidated subsidiary of the covered company. Committed servicer advance facilities also attract outflow amounts under the Final Rule.

### (i) Sponsored Securitization Transactions that ARE Consolidated

If a covered company consolidates an SPE issuing entity, then any outflows under the securitization transaction and inflows from the securitized assets are attributed to the covered company. The fact that the obligations of the SPE are non-recourse to the SPE (other than assets owned by the SPE) is irrelevant for these purposes (and for all purposes under the LCR). Under the Final Rule, non-recourse indebtedness creates outflows in the same manner as recourse indebtedness.

Outflows for consolidated SPEs occur under Section 32(j) or Section 32(l) of the Final Rule. Section 32(j) covers secured transaction outflow amounts for transactions "that mature within 30 days or less of the calculation date."[108] This leads to the question of when a securitization transaction "matures." The determination of when an obligation to make a principal payment in a securitization transaction "matures" will depend on a variety of factors, including whether the transaction is structured as a "pass-through" and whether the securitization documents set forth specific principal amounts that are payable prior to the final maturity date of the debt obligation.

Interest due and payable in specific amounts is either a secured funding transaction outflow under Section 32(j) of the Final Rule if it is deemed to "mature" in the relevant calculation period or is an

108 See the discussion in Section V.C.3.

outflow under Section 32(l) of the Final Rule, which covers contractual amounts not otherwise covered as an outflow payable under legally binding agreements during the calculation period.

**(ii) Sponsored Securitization Transactions That ARE NOT Consolidated**

Sponsored securitization transactions that are not consolidated would be assigned outflow amounts under Section 32(b) of the Final Rule. The outflow amount for a given calculation period would be the greater of the amount of debt obligations maturing during the calculation period (calculated as described above) and the maximum amount of funding the bank may be required to fund during the calculation period under a funding agreement.[109]

**(iii) Committed Servicer Advance Facilities**

While not subject to a dedicated section of the Final Rule, committed servicer advance facilities are treated as commitments and assigned outflow amounts under Section 32(e) of the Final Rule. If the covered company is either the sponsor of the transaction or consolidates the issuing SPE, there is no need to double count any advances that would be used to make principal and interest payments that are already attributable to the covered company.

**D. Inflows**

If a securitization transaction is consolidated by a covered company, amounts payable with respect to the securitized assets would constitute inflow amounts of the covered company. The Final Rule sets forth inflow categories and assigns an inflow rate for each inflow category ranging from 0% to 100%. The inflow rates apply only to payments that are contractually payable to the covered company during the relevant calculation period and not to amounts actually received by the covered company during the calculation period. Therefore, for example, amounts payable with respect to credit card receivables would be "retail cash" inflows and assigned an inflow amount equal to 50% of all payments contractually payable from the cardholders during the relevant calculation period under Section 33(c) of the Final Rule.

If a sponsored securitization transaction is not consolidated by a covered company, then no inflow amounts would apply with respect to the securitized assets.

**VI. Compliance Requirements**

The effective date of the Final Rule is January 1, 2015.[110] Consistent with the Proposed Rule, the Final Rule implements a graduated compliance timeframe. On January 1, 2015, all covered companies will be required to maintain an LCR of 80%[111] and, beginning on January 1, 2016, all covered companies will be

109 See the discussion in Section V.C.2. above.

110 Section 1(b)(2) of the Final Rule.

111 Section 50(a)(1) and (2) of the Final Rule.



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required to maintain an LCR of 90%.[112] On January 1, 2017, covered companies are required to be fully compliant with an LCR of 100%.[113]

Recognizing the operational challenges of implementing the Final Rule's daily LCR calculation requirements, the Agencies have delayed implementation of the daily calculation requirement.[114]

Certain covered companies are required to calculate their LCR on the last business day of each calendar month from January 1, 2015 to June 30, 2015.[115] Then, those covered companies must calculate their LCR on each business day beginning on July 1, 2015.[116]

Covered companies subject to the transition requirements set forth above include:

- covered companies that are depository institution 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.[117]

All other covered companies are required to calculate their LCR on the last business day of the calendar month from January 1, 2015 to June 30, 2016[118] and must calculate their LCR each business day beginning on July 1, 2016.[119]

## VII. Modified LCR Rule

As discussed above, the 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 are not required to use the Final Rule's LCR.[120]

The modified LCR rule is a simpler and less stringent form of the Final Rule's LCR. Among the differences between the LCR and the Modified LCR:

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112 Section 50(a)(3) of the Final Rule.

113 Section 50(a)(4) of the Final Rule.

114 *Adopting Release*, *supra* note 1 at 21.

115 Section 50(a)(1) of the Final Rule.

116 Section 50(a)(2) of the Final Rule.

117 Section 50(a) of the Final Rule.

118 Section 50(b)(1) of the Final Rule.

119 Section 50(b)(3) of the Final Rule.

120 Section 249.60(a) of Board's Rule.

- Banks subject to the Modified LCR do not need to include the "add-on" requirement to total net cash outflows. The Modified LCR denominator is based on total net outflows for the relevant calculation period.[121]
- The Modified LCR provides for a 30% haircut for outflows with no contractual maturity date. This includes credit and liquidity commitments to special purpose entities, which therefore have assumed outflow rates that are 70% of the assumed outflow rates that will apply for banks subject to the LCR.[122]
- The Modified LCR provides for a monthly rather than a daily calculation that starts January 1, 2016.[123]
- A liquidity coverage ratio of 90% is required under the Modified LCR for 2016 and 100% thereafter.[124]

## VIII. Enforcement

The Agencies recognize that, under certain circumstances, it may be necessary for a covered company's LCR to fall briefly below 100% to fund unanticipated liquidity needs. However, the Agencies also believe that an LCR deficiency may indicate serious liquidity risk. Therefore, the Final Rule establishes a framework for a flexible supervisory response when a covered company's LCR falls below the required threshold.

- A covered company must notify the appropriate Federal banking agency on any business day that its LCR is less than the required threshold.[125]
- If a covered company is calculating its LCR daily and its LCR is below 100% for three consecutive business days, the covered company must submit to its appropriate Federal banking agency a plan for remediation of the shortfall.[126]
- If a covered company is calculating its LCR monthly, it must promptly consult with the appropriate Federal banking agency to determine whether a plan would be required if its LCR is below its minimum requirement as of the last day of the calendar month.[127]

121 Under the Proposed Rule, a modified LCR company would have determined outflow rates based on a 21 calendar-day stress scenario rather than a 30 calendar-day stress scenario.

122 Section 249.63(a) of Board's Rule.

123 Section 249.61(b)(1) of Board's Rule.

124 Section 249.61(b)(1) and (2) of Board's Rule.

125 Section 40(a) of the Final Rule.

126 Section 40(b)(2) of the Final Rule.

127 Section 40(b)(1) of the Final Rule.



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Notes:

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