SUPPLEMENTAL LEVERAGE RATIO & LIQUIDITY COVERAGE RATIO

Supplementary Leverage Ratio

Background and Overview

U.S. and international banking organizations are subject to a range of regulatory capital requirements. The Supplementary Leverage Ratio (SLR) is the newest of these requirements.

Capital, at the most basic level, is the difference between a bank's assets and liabilities. It is a financial cushion used to absorb unexpected losses to protect deposits and other liabilities. In the numerator, different capital ratios require different types of capital, such as tier 1 capital or common equity tier 1 capital. In the denominator, capital ratios may be based on a "risk-weighted" measure or a non-risk-weighted leverage measure.

$$Capital\ Ratio = \frac{Capital}{Assets}$$

The Basel Committee on Banking Supervision (BCBS), a global group of bank supervisors, strengthened capital requirements in 2010 in response to concerns that insufficient capital contributed to and worsened the 2008 financial crisis. This package of regulatory capital reforms, known as Basel III, included the SLR.

The SLR is intended to be a "backstop" to the risk-weighted capital requirements and limit the amount of leverage that a banking organization may incur using a blunt, non-risk-based measure. Regulators believed that the risk-weighted capital requirements misjudged the actual risk of certain assets, such as residential mortgages, and as a result banks did not hold sufficient capital to absorb losses. In response, the SLR intentionally does not distinguish among assets based on risk. Because the SLR is not risk-sensitive, a bank must hold the same amount of capital against low risk assets (e.g., cash and US Treasuries) as higher risk assets (e.g., corporate equities and securitizations). And, unlike other leverage requirements, the SLR includes both on- and off-balance sheet exposures in a "total leverage exposure."

$$Supplementary\ Leverage\ Ratio = \frac{Tier\ 1\ Capital}{Total\ Leverage\ Exposure}$$

The BCBS finalized a 3% SLR requirement in 2010 and revised the methods to measure on- and off-balance sheet exposures (the denominator) in January 2014.

US Implementation of the SLR

The US bank regulators (the Federal Reserve, Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency) implemented the 3% SLR in 2013 as part of the revised Basel III capital rules. This 3% SLR applies to the largest banking organizations with $250 billion or more in total consolidated assets or $10 billion or more in on-balance sheet foreign exposure.

In April 2014, the US bank regulators finalized an "enhanced" SLR on the 8 US global systemically important banks (G-SIBs) and their insured depository institutions. This heightened standard is US-specific and not required by the BCBS. As part of the "enhanced" SLR, the 8 US G-SIBs must meet a 5% SLR at the holding company level and a 6% SLR at the bank level. Banks also must hold a cushion above this 6% to account for volatility.

In September 2014, the US bank regulators revised the methods to measure on- and off-balance sheet exposures in the SLR denominator to be consistent with the Basel revisions. These revisions marginally improved the SLR, including changes to:

- Recognize cash variation margin in derivatives transactions;
- Allow netting of securities financing transactions (SFTs) when the securities are not re-hypothecated;
- Adopt a less punitive treatment of off-balance sheet commitments; and
- Allow daily averaging of on-balance sheet assets to reduce volatility in the SLR calculation.

Implications for Large US Banking Organizations

The SLR does not become fully effective until January 1, 2018. But banking organizations are already making changes to comply with the SLR given that the final rules require public disclosures beginning January 1, 2015.

The SLR makes products and services that use the balance sheet more expensive. The SLR has the largest impact on the banks that are "bound" by the SLR rather than the risk-based capital requirements. That is, each banking organization must hold the highest amount of capital required by any of its capital ratios, whether risk-based or the SLR. Custody and trust banks and broker-dealer banking organizations are more likely to be bound by the SLR because they have a relatively higher proportion of low risk assets. As a result, their capital requirements under the risk-insensitive SLR are likely to be higher than under the risk-based capital requirements.

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Conversely, banking organizations with relatively higher risk assets, such as universal banks, are more likely to be bound by the risk-based requirements.

The SLR has a unique impact on custody and trust banks and other business models with a high proportion of low risk assets. Because the SLR is not risk sensitive, these low risk assets attract the same capital charge as higher risk, higher yielding assets. As a result, the SLR may encourage these banks to "barbell" their balance sheets by holding higher risk and higher yielding assets to balance out the capital charge from the large amount of lower risk, lower yielding assets required by the Liquidity Coverage Ratio (LCR).

Further, the "enhanced" 5%/6% SLR places US G-SIBs at a disadvantage compared with their foreign counterparts, although this may soon change as other jurisdictions are also contemplating heightened leverage requirements.

To manage these requirements, firms may shed assets, compress trades (e.g., increase offsetting trades, better hedge credit derivatives), and increase holdings of credit risk assets.

Next Steps

Firms are still evaluating the optimal asset mix to balance the liquid asset requirements of the LCR with the high capital charge of the SLR. This is a difficult exercise, and the appropriate mix remains a moving target as regulators continue to develop new capital and liquidity regulations and change monetary policy.

In the capital space, an international group is working on "total loss-absorbing capacity" (TLAC), which will require banks to hold a minimum amount of capital, long-term debt, and certain other liabilities that can be "bailed-in" in the event of resolution. The Federal Reserve is contemplating an additional capital surcharge for banks that rely heavily on short-term wholesale funding and higher capital surcharges for the 8 US G-SIBs.

In the liquidity space, there are forthcoming rules on a long-term liquidity requirement known as the net stable funding ratio. The Federal Reserve's rules on liquidity stress testing and liquidity risk management also will become effective shortly.

Finally, the SLR may have less of an impact as the money supply contracts and there are fewer cash deposits in the system, leading to smaller overall balance sheets.

Liquidity Coverage Ratio

Background and Overview

The Liquidity Coverage Ratio (LCR) is the first minimum, quantitative, regulatory liquidity requirement applied to banking organizations. The Basel Committee on Banking Supervision (BCBS), a global group of bank supervisors, developed the LCR in response to concerns that a lack of liquidity contributed to and worsened the 2008 financial crisis.

The LCR is intended to promote the short-term resilience of banking organizations, absorb shocks from financial and economic stress, and improve the measurement and management of liquidity risk. To achieve these goals, the LCR requires a company to hold enough "high quality liquid assets" (HQLA) to meet net cash outflows over a stressed 30-day period.

$$\frac{High\ Quality\ Liquid\ Assets}{Net\ Cash\ Outflows} > 100\%$$

The LCR rules specify which types of assets count as HQLA (e.g., cash and US Treasuries) and how to calculate cash outflows (e.g., deposit run-offs) and inflows (e.g., receipt of loan payments).

US Implementation of the LCR

In October 2013, the US bank regulators (the Federal Reserve, Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency) proposed rules to implement the Basel LCR in the US. The proposed US LCR rule was significantly more conservative than the Basel LCR, and members of the public filed over 100 comment letters in response.

US bank regulators finalized the LCR rule in September 2014. The final LCR applies to the largest banking organizations with $250 billion or more in total assets or $10 billion or more in on-balance sheet foreign exposure, and to insured depository institutions with $10 billion or more in total assets that are subsidiaries of such companies. A less stringent, "modified" LCR applies to banking organizations with less than $250 billion but $50 billion or more in total assets.

Following comments from BNY Mellon and others in the industry, the final US LCR rule addressed several – but not all – of the issues in the proposed rule. For instance, the final rule:

- Eliminates some of the overly conservative run-off assumptions regarding non-maturity deposits;
- Adopts a new methodology that is designed to capture maturity mismatches only from certain types of transactions, such as repos and reverse repos with financial sector entities;
- Broadens the types of deposits that qualify for more favorable treatment as "operational deposits," such as mutual fund and certain correspondent banking deposits;

- Delays the data-intensive daily reporting requirement to July 2015 for the largest banking organizations and to July 2016 for other banking organizations; and
- Leaves open the possibility that certain municipal securities may be sufficiently liquid to be included as HQLA, which would be proposed in a future rulemaking.

Implications for Large US Banking Organizations

Banking organizations covered by the final LCR rule must meet 80 percent of the standard beginning in 2015, 90 percent in 2016, and 100 percent in 2017. This US implementation timeline is a full two years ahead of the international schedule, which does not require full compliance until 2019. As a result, US banking organizations are already making changes to manage the LCR whereas their foreign counterparts may not yet be.

The final US LCR rule mitigates many of the LCR concerns for custody and trust banks. The proposed US LCR rule did not appropriately capture stable and low risk sources of deposit funding from custody and other servicing relationships. The final rule allows a wider range of client deposits, such as cash from mutual funds and certain correspondent banking relationships, to receive LCR credit. As a result, banks may hold less HQLA against these deposits and place them into higher yielding assets. Other types of client deposits, such as cash from hedge funds and private equity funds, continue to be expensive from an LCR perspective.

For retail, universal, and broker-dealer banking organizations, the final rule improves the treatment of certain retail funding, retail brokered deposits, collateralized deposits (e.g., for public sector and corporate trust deposits), committed facilities to special purpose entities that do not issue securities or commercial paper, and assets held in segregated accounts in accordance with regulatory requirements for the protection of client trading assets.

Although these changes offer some relief, the agencies did not change other major aspects of the proposal and the final rule remains more stringent than the international Basel LCR. For example, the final rule generally does not expand the categories of assets that qualify as HQLA or further adjust the rules to recognize the unique nature of prime brokerage services. The treatment of derivatives and a company's debt securities also remains largely unchanged.

Next Steps

The LCR is only one component of a broader liquidity framework. Other existing and forthcoming requirements include:

- Liquidity stress test and risk management requirements in the Federal Reserve's enhanced prudential standards under Section 165 of the Dodd-Frank Act;
- Comprehensive Liquidity Analysis and Review, which is similar to stress testing;
- 4G and 5G liquidity reporting requirements;
- Forthcoming rules on the net stable funding ratio, which addresses longer-term liquidity risks by requiring enough stable funding over a one-year time horizon; and
- Potential intraday liquidity monitoring rules.

The Federal Reserve, Financial Stability Board, and other regulators also are increasingly focused on the more general liquidity risks of short-term wholesale funding, asset fire sales, and matched books. The LCR addresses some of these risks by increasing the liquidity charge on committed credit and liquidity facilities and securities financing transactions (SFTs), but the LCR only applies to SFTs that mature within 30 days. As a result, regulators are contemplating other reforms to address the liquidity risks of short-term wholesale funding and SFT financing, including a heightened capital surcharge for firms that rely heavily on short-term wholesale funding and minimum margin and haircut requirements for SFTs. These requirements could increase costs for broker-dealer banking organizations and other banks that fund or service these arrangements.