Liquidity Coverage Ratio and Political Subdivisions

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WHAT IS BASEL?

Established in the early 1970s, the Basel Committee is an international committee on bank supervision. The goal of the Committee is to develop and coordinate standards and guidelines of banking supervision. Basel I, known as the Basel Accord, was developed in 1988 and implemented in the early 1990s. Its focus was on credit risk and appropriate Risk Weighting of Assets. Basel II was established in the mid-2000s with a focus on capital requirements to safeguard against operational and financial risks and to enhance disclosure requirements and supervisory review.

In 2010, as a result of the financial crisis, Basel III was introduced with a focus on capital, risk and liquidity reform. One of the main components of Basel III is the Liquidity Coverage Ratio (LCR) which significantly changes how banks view deposits.

HOW IS LCR CALCULATED?

The general calculation for U.S. LCR is the amount of High Quality Liquid Assets (HQLAs) divided by the total net cash outflows. The LCR requires a banking organization's stock of unencumbered HQLA to be at least 100% of its total net cash outflows over a 30-day stress period.

<u>LCR</u>

HQLAs ÷ Total Net Cash Outflows ≥ 100%

There are a variety of asset types (a combination of level 1, 2a, and 2b), cash flows and percentage caps associated with the LCR calculation, but the purpose here is to focus on its effects relating to depositors, specifically Public Sector Entities (PSEs).[1]

WHAT IS THE EFFECT OF BANKING RELATIONSHIPS WITH PSE'S?

On the asset side, state and municipal securities are currently excluded from counting as HQLA. However, a memorandum dated August 29, 2014 included a recommendation for the Board of Governors to develop a proposal for public comment to include highly liquid municipal securities as HQLAs.[2]

On the surface, not being able to include municipal securities as highly liquid appears negative, but in fact municipal securities still has positive attributes from a collateralization perspective.

Most municipal depositors can accept municipal securities as a form of collateral. So in most cases, municipal bonds can be multipurpose as an investment and form of collateral.

On the liability side, a major concern is how the new LCR requirements are changing the relationship of a bank and depositor. In the case of public sector entities (PSEs), they were originally included in the unwind calculation for determining HQLA. According to a publication from the law firm Sullivan and Cromwell:

"…the Final Rule does not require a covered company to apply the unwind requirement to certain collateralized deposits for purposes of calculating HQLA, accepting commenters' arguments that preferred deposits and corporate trust deposits that must be collateralized under applicable law were unlikely to be subject to the manipulation the unwind requirement is meant to address. The Final Rule includes the following new definition of collateralized deposits to clarify the deposits that are not subject to the requirement: a deposit of a public-sector entity held at the covered company and that gives the depositor, as holder of the lien, priority over the assets in the event the covered company enters into receivership, bankruptcy, insolvency, liquidation, resolution or similar proceeding..." [3]

In a memorandum on the draft Final Rule of the Federal Reserve Board dated August 29, 2014, the staff of the Board stated:

"…Many commenters expressed concerns relating to the treatment in the NPR [notice of proposed rulemaking] of secured public sector and corporate trust deposits (together; collateralized deposits). The NPR would have included the collateral securing collateralized deposits within the 40 percent limit on level 2 liquid assets and a 15 percent limit on level 2B liquid assets and would have assumed the immediate return of level 2 collateral securing the deposit, potentially increasing the LCR requirement with respect to those deposits. This treatment is the consequence of a general rule that applied to all secured liabilities secured by HQLA with no, or short-term, maturity dates, such as overnight repurchase agreements." [2]

And according to the Sullivan & Cromwell publication:

"…The Final Rule assigns outflow rates to all secured deposits including collateralized public sector and corporate trust deposits with a maturity within the 30-calendar-day stress period based on the quality of the collateral used to secure the deposits. Secured deposits secured by Level 1 liquid assets will be assigned a 0% outflow rate while deposits secured by Level 2A liquid assets will be assigned a 15% outflow rate. The outflow rate for secured deposits will not be greater than the equivalent outflow rate for an unsecured deposit for the same counterparty." [3]

Traditionally, PSE depositors have been viewed as a stable source of funding for banks. In an article by Securities Finance Monitor entitled "Updates to the LCR rules: some winners, some losers," a passage cited from The Clearing House provided the following comments on a February 19, 2014 post:

"…The treatment of secured deposits of U.S. municipalities and public sector entities ("PSEs") as secured funding transactions that are subject to the requirement to calculate HQLA on an

unwind basis leads to substantial and unjustified negative distortions in the HQLA calculation. The U.S. LCR as proposed could create a strong incentive for institutions to stop offering these products for PSEs, which could cause U.S. municipalities to have substantial practical difficulties in providing critical public services to citizens, meeting payroll for public servants, and more generally paying day-to-day bills…" [4]

Regulation, regardless of intention, has unseen consequences. Through public comment and lobbying efforts, the modification to the treatment of PSEs in the outflow calculation, allows banks and PSEs to maintain mutually productive relationships. This revision is a victory for banks, states and municipalities.

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1. U.S. Basel III Liquidity Coverage Ratio Final Rule Visual Memorandum: September 23, 2014, Davis Polk & Wardwell LLP

2. Draft final rule to implement a liquidity coverage ratio requirement: August 29, 2014, Memorandum of the Staff to the Board of Governors of the Federal Reserve System

3. Basel III Liquidity Framework: September 9, 2014, Sullivan & Cromwell LLP

4. Updates to the LCR rules: some winners, some losers: September 17, 2014, Securities Finance Monitor

5. Basel III: The Liquidity Coverage Ratio and liquidity risk monitoring tools: January 2013, Basel Committee on Banking Supervision. http://www.bis.org/
   **The citations gleaned from this Basel III source can be found throughout this article.*

About D. James Lutter

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