April 26, 2016

MEMORANDUM TO: Board of Directors

FROM: Doreen R. Eberley, Director
Division of Risk Management Supervision

SUBJECT: Notice of Proposed Rulemaking to Implement Liquidity Risk Standards for Certain FDIC Supervised Institutions

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Recommendation: Staff recommends that the FDIC Board ("Board") approve publication in the *Federal Register* of the attached Notice of Proposed Rulemaking ("NPR" or "proposed rule") that would implement quantitative liquidity requirements, including a net stable funding ratio ("NSFR"), consistent with a liquidity standard adopted by the Basel Committee on Banking Supervision ("BCBS") in October 2014, for certain banking organizations with $250 billion or more in total consolidated assets or $10 billion or more in total on-balance sheet foreign exposure, and to their consolidated subsidiaries that are depository institutions with $10 billion or more in total consolidated assets. The NPR also contains a separate proposal by the Board of Governors of the Federal Reserve System ("FRB") to apply a modified version of the NSFR to certain depository institution holding companies with assets greater than $50 billion. If approved, the NPR would be issued jointly by the FDIC, the FRB, and the Office of the Comptroller of the Currency ("OCC") (collectively, "the agencies") and would be published in the *Federal Register* with a comment period that would end on August 5, 2016.

Staff has carefully considered the potential impact of this NPR, and has sought to minimize any implementation burden associated with the proposal to the extent possible.

Concur:

Charles Yi
General Counsel

I. Background

The 2007-2009 financial crisis exposed the vulnerability of large and internationally active banking organizations to liquidity shocks. For example, before the crisis, many large banking organizations lacked robust liquidity risk management metrics and relied excessively on short-term wholesale funding to support less liquid assets.[1] In addition, these banking organizations did not sufficiently plan for longer-term liquidity risks, and their control functions failed to effectively challenge funding decisions or sufficiently plan for possible disruptions to the organization's regular sources of funding. Instead, the control functions reacted only after funding shortfalls arose.

During the crisis, many large banking organizations experienced severe contractions in the supply of funding. As access to funding became limited and asset prices fell, many banking organizations faced the possibility of default and failure. The threat this presented to the financial system caused governments and central banks around the world to provide significant levels of support to these institutions to maintain global financial stability. This experience demonstrated a need to address these shortcomings at large banking organizations and to implement a more rigorous approach to identifying, measuring, monitoring, and limiting reliance on less stable sources of funding.

Since the 2007-2009 financial crisis, the agencies have developed quantitative and qualitative standards focused on strengthening banking organizations' overall risk management, liquidity positions, and liquidity risk management. By improving banking organizations' ability to absorb shocks arising from financial and economic stress, these measures, in turn, promote a more resilient banking sector and financial system. This work has taken into account ongoing

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[1] See Senior Supervisors Group, Risk Management Lessons from the Global Banking Crisis of 2008, (October 21, 2009), available at https://www.newyorkfed.org/medialibrary/media/newsevents/news/banking/2009/SSG_report.pdf

supervisory reviews and analyses in the United States, as well as international discussions regarding appropriate liquidity standards.[2]

The agencies have implemented or proposed several measures to improve the liquidity positions and liquidity risk management of supervised banking organizations. First, the agencies adopted the liquidity coverage ratio ("LCR") rule in September 2014,[3] which requires certain large banking organizations to hold a minimum amount of high-quality liquid assets ("HQLA") that can be readily converted into cash to meet net cash outflows over a 30-calendar-day period. Second, pursuant to section 165 of the Dodd-Frank Wall Street Reform and Consumer Protection Act[4] ("Dodd-Frank Act") and in consultation with the OCC and the FDIC, the FRB adopted general risk management, liquidity risk management, and stress testing requirements for bank holding companies with total consolidated assets of $50 billion or more in Regulation YY.[5] Third, the FRB adopted a risk-based capital surcharge for global systemically important banking organizations ("GSIBs") in the United States that is calculated based on a bank holding company's risk profile, including its reliance on short-term wholesale funding ("GSIB surcharge rule").[6] Fourth, the FRB recently proposed a long-term debt requirement and a total loss-absorbing capacity ("TLAC") requirement that would apply to U.S. GSIBs and the U.S. operations of certain foreign GSIBs, and would require these firms and operations to have

[2] See, e.g., Principles for Sound Liquidity Risk Management and Supervision (September 2008), available at http://www.bis.org/publ/bcbs144.htm; Basel III: The Liquidity Coverage Ratio and liquidity risk monitoring tools (January 2013), available at http://www.bis.org/publ/bcbs238.pdf; Basel III: the net stable funding ratio (October 2014), available at http://www.bis.org/bcbs/publ/d295.pdf.

[3] "Liquidity Coverage Ratio: Liquidity Risk Measurement Standards," 79 FR 61440 (October 10, 2014), codified at 12 CFR part 50 (OCC), 12 CFR part 249 (FRB), 12 CFR part 329 (FDIC).

[4] Pub. L. No. 111-203, 124 Stat. 1376, 1423-1432 (2010) § 165, codified at 12 U.S.C. 5365.

[5] See "Enhanced Prudential Standards for Bank Holding Companies and Foreign Banking Organizations," 79 FR 17240 (March 27, 2014), codified at 12 CFR part 252.

[6] "Regulatory Capital Rules: Implementation of Risk-Based Capital Surcharges for Global Systemically Important Bank Holding Companies," 80 FR 49082 (August 14, 2015).

sufficient amounts of equity and eligible long-term debt to improve their ability to absorb significant losses and withstand financial stress, which also would improve the funding profile of these firms.[7] The proposed rule would complement these measures as well as existing supervisory guidance.[8]

In developing the proposed minimum stable funding requirement, the agencies and their international counterparts in the BCBS considered a number of structural funding metrics before developing the net stable funding ratio standard published by the Basel Committee on Banking Supervision ("BCBS")[9] in October 2014 ("Basel III NSFR").[10] The proposed rule would be consistent with the Basel III NSFR and the net stable funding ratio disclosure standards published by the BCBS in June 2015.[11]

II. Overview of the Proposed Rule

A. *Scope*

The proposed NSFR requirement would apply to the same large and internationally active banking organizations that are subject to the LCR rule ("covered companies"): (1) bank holding companies, savings and loan holding companies without significant commercial or insurance

[7] "Total Loss-Absorbing Capacity, Long-Term Debt, and Clean Holding Company Requirements for Systemically Important U.S. Bank Holding Companies and Intermediate Holding Companies of Systemically Important Foreign Banking Organizations; Regulatory Capital Deduction for Investments in Certain Unsecured Debt of Systemically Important U.S. Bank Holding Companies," 80 FR 74926 (November 20, 2015).

[8] See, e.g., OCC, FRB, FDIC, Office of Thrift Supervision, and National Credit Union Administration, "Interagency Policy Statement on Funding and Liquidity Risk Management," 75 FR 13656 (March 22, 2010); Supervision and Regulation Letter 12-17 (December 12, 2012).

[9] The BCBS is a committee of banking supervisory authorities that was established by the central bank governors of the G10 countries in 1975. It currently consists of senior representatives of bank supervisory authorities and central banks from Argentina, Australia, Belgium, Brazil, Canada, China, France, Germany, Hong Kong SAR, India, Indonesia, Italy, Japan, Korea, Luxembourg, Mexico, the Netherlands, Russia, Saudi Arabia, Singapore, South Africa, Sweden, Switzerland, Turkey, the United Kingdom, and the United States. Documents issued by the BCBS are available through the Bank for International Settlements Website at http://www.bis.org.

[10] See supra note 1.

[11] "Net Stable Funding Ratio disclosure standards" (June 2015), available at http://www.bis.org/bcbs/publ/d324.pdf (Basel III NSFR Disclosure Standards).

operations, and depository institutions that, in each case, have $250 billion or more in total consolidated assets or $10 billion or more in on-balance sheet foreign exposure,[12] and (2) depository institutions with $10 billion or more in total consolidated assets that are consolidated subsidiaries of such bank holding companies and savings and loan holding companies.

The proposed rule would apply to large banking organizations that tend to have larger and more complex liquidity risk profiles than smaller and less internationally active banking organizations. While banking organizations of any size can face threats to their safety and soundness based on an unstable funding profile, covered companies' scale, scope, and complexity require heightened measures to manage their liquidity risk. In addition, covered companies with total consolidated assets of $250 billion or more can pose greater risks to U.S. financial stability than smaller banking organizations because of the scale and breadth of their activities and their interconnectedness with the financial sector. Consequently, threats to the availability of funding to larger firms pose greater dangers to the financial system and economy. Likewise, the foreign exposure threshold identifies firms with a significant international presence, which may also present risks to financial stability for similar reasons. By promoting stable funding profiles for large, interconnected institutions, which, as a group, also tend to engage in a broad variety of activities and transactions, the proposed rule would strengthen the safety and soundness of covered companies and promote a more resilient U.S. financial system and global financial system.

The proposed rule would also apply the NSFR requirement to depository institutions that are the consolidated subsidiaries of covered companies and that have $10 billion or more in total

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[12] Total consolidated assets for the purposes of the proposed rule would be as reported on a banking organization's most recent year-end Consolidated Reports of Condition and Income or Consolidated Financial Statements for Bank Holding Companies, Federal Reserve Form FR Y-9C. Foreign exposure data would be calculated in accordance with the Federal Financial Institution Examination Council 009 Country Exposure Report.

consolidated assets. These large depository institution subsidiaries play a significant role in covered companies' funding structures and operations, and present a relatively larger exposure to the FDIC's Deposit Insurance Fund than most insured institutions because of the greater volume of their deposit-taking and lending activities. To reduce the potential impacts of a liquidity event at such large depository institution subsidiaries, the proposed rule would require that such institutions independently maintain sufficient funding.

The FRB is also proposing at the same time to implement a modified version of the NSFR requirement for bank holding companies and savings and loan holding companies without significant insurance or commercial operations that, in each case, have $50 billion or more, but less than $250 billion, in total consolidated assets and less than $10 billion in total on-balance sheet foreign exposure.

B. *Net Stable Funding Ratio*

The proposed rule would require a covered company to maintain an amount of available stable funding ("ASF") that is no less than the amount of its required stable funding ("RSF") on an ongoing basis. A covered company's NSFR would be expressed as a ratio of its ASF amount (the "numerator") to its RSF amount (the "denominator"). A covered company's ASF amount would serve as a weighted measure of stability of the company's funding over a one-year time horizon. A covered company would calculate its ASF amount by applying standardized weightings ("ASF factors") to its equity and liabilities based on their expected stability. Similarly, a covered company would calculate its RSF amount by applying standardized weightings ("RSF factors") to its assets, derivative exposures, and commitments based on their liquidity characteristics. These characteristics would include credit quality, tenor, encumbrances, counterparty type, and characteristics of the market in which an asset trades, as applicable.

C. *Available Stable Funding Amount (The Numerator)*

Under the proposed rule, a covered company's ASF amount would measure the stability of its equity and liabilities. An ASF amount that equals or exceeds a covered company's RSF amount would be indicative of a stable funding profile over the NSFR's one-year time horizon. A covered company's ASF amount would equal the sum of the carrying values of the covered company's NSFR regulatory capital elements and NSFR liabilities, each multiplied by a specified ASF factor. ASF factors would be assigned based on the stability of each category of NSFR liability or NSFR regulatory capital element over the NSFR's one-year time horizon. A covered company would be able to include in its ASF amount the ASF amount of a consolidated subsidiary only to the extent that the funding of the subsidiary supports the RSF amount associated with its own assets or is readily available to support RSF amounts associated with the assets of the covered company outside the consolidated subsidiary

1. ASF Factor Characteristics

The proposed rule would use a set of ASF factors to measure the relative stability of a covered company's NSFR liabilities and NSFR regulatory capital elements over a one-year time horizon. ASF factors would be scaled from zero to 100 percent, with zero percent representing the lowest stability and 100 percent representing the highest stability. The proposed rule would assign an ASF factor to a category of NSFR liabilities or NSFR regulatory capital elements based on three characteristics relating to the stability of the funding, as applicable: funding tenor, funding type, and counterparty type.

a. *Funding tenor*

The proposed rule would generally treat funding that has a longer effective maturity as more stable than shorter-term funding. The proposed rule would group funding maturities into three categories: less than six months, six months or more but less than one year, and one year or more. The proposed rule would treat loans to the covered company with a remaining maturity of one year or more as the most stable because a covered company would not need to roll the loan over during the NSFR's one-year time horizon, and would treat a loan with a remaining maturity of less than six months or an open maturity as the least stable because a covered company would need to roll it over in the short term. The proposed rule would treat a loan from financial sector entities that matures in six months or more but less than one year as partially stable because a covered company would not need to roll it over in the shorter-term but would still need to roll it over before the end of the NSFR's one-year time horizon.

b. *Funding type*

The proposed rule recognizes that certain types of funding are inherently more stable than other types, independent of stated tenor. For example, the proposed rule would assign a higher ASF factor to stable retail deposits relative to other retail deposits, due in large part to the presence of deposit insurance coverage and other stabilizing features that reduce the likelihood of a depositor discontinuing the funding across a broad range of market conditions. Similarly, the proposed rule would assign a higher ASF factor to operational deposits than to certain other forms of short-term, wholesale deposits based on the provision of services linked to an operational deposit. Likewise, the proposed rule would assign different ASF factors to different categories of retail brokered deposits based on features that tend to make these forms of deposit more or less stable.

c. *Counterparty type*

The proposed rule would recognize that the stability of a covered company's funding may vary based on the type of counterparty providing it. Accordingly, the proposed rule would treat most types of funding provided by retail customers or counterparties as more stable than similar types of funding provided by wholesale customers or counterparties. It would also generally treat short-term funding provided by financial sector entities as less stable than similar types of funding provided by non-financial wholesale customers or counterparties.

2. ASF Consolidation

In general, the proposed rule would require a covered company to calculate its NSFR on a consolidated basis. When calculating ASF amounts from a consolidated subsidiary, the proposed rule would require a covered company to take into account restrictions on the ASF of the consolidated subsidiary to support assets, derivative exposures, and commitments of the covered company held at entities other than the subsidiary. Specifically, a covered company would only be able to include in its ASF amount any portion of a consolidated subsidiary's ASF amount in excess of the consolidated subsidiary's RSF amount to the extent the consolidated subsidiary may transfer assets to the top-tier entity of the covered company, taking into account statutory, regulatory, contractual, or supervisory restrictions.

D. Required Stable Funding Amount (The Denominator)

Under the proposed rule, a covered company's RSF amount would represent the minimum level of stable funding that the covered company would be required to maintain. A covered company's RSF amount would be based on the liquidity characteristics of its assets, derivative exposures, and commitments. In general, the less liquid an asset over the NSFR's one-year time horizon, the greater extent to which the proposed rule would require it to be supported by stable funding. By requiring a covered company to maintain more stable funding to support less liquid assets, the proposed rule would reduce the risk that the covered company could be required to monetize the assets for less than full value, including potentially at fire sale prices, or otherwise in a manner that contributes to disorderly market conditions.

1. RSF Factor Characteristics

The proposed rule would use a set of standardized weightings, or RSF factors, to determine the amount of stable funding a covered company must maintain. Specifically, a covered company would calculate its RSF amount by multiplying the carrying values of its assets, the undrawn amounts of its commitments, and its measures of derivative exposures by the assigned RSF factors. RSF factors would be scaled from zero percent to 100 percent based on the liquidity characteristics of an asset, commitment, or derivative exposure.

The proposed rule provides that a zero percent RSF factor would not require the asset, derivative exposure, or commitment to be supported by ASF and provides that a 100 percent RSF factor would require the asset, commitment, or derivative exposure to be fully supported by ASF. Accordingly, the proposed rule would generally assign a lower RSF factor to more liquid assets, commitments, and exposures and a higher RSF factor to less liquid assets, commitments, and exposures. For purposes of assigning an RSF factor, the proposed rule would measure expected liquidity over the NSFR's one-year time horizon based on the following characteristics, considered collectively for each asset, as applicable: credit quality, tenor, type of counterparty, market characteristics, and encumbrance.

a. *Credit quality*

Credit quality is a factor in an asset's liquidity because market participants tend to be more willing to purchase higher credit quality assets across a range of market and economic conditions, but especially in a stressed environment (sometimes called "flight to quality"). The demand for higher credit quality assets, therefore, is more likely to persist and such assets are more likely to have resilient values, allowing a covered company to monetize them more readily. Assets of lower credit quality, in contrast, are more likely to become delinquent, and that increased credit risk makes these assets less likely to hold their value. As a result, the proposed rule generally would require assets of lower credit quality to be supported by more stable funding to reduce the risk that a covered company may have to monetize the lower credit quality asset at a discount.

b. *Tenor*

In general, the proposed rule would require a covered company to maintain more stable funding to support assets that have a longer tenor because of the greater time remaining before the covered company will realize inflows associated with the asset. In addition, assets with a longer tenor may liquidate at a discount because of the increased market and credit risks associated with cash flows occurring further in the future. Assets with a shorter tenor, in contrast, would require a smaller amount of stable funding under the proposed rule because a covered company would have access to the inflows under these assets sooner. Thus, the proposed rule generally would require less stable funding for shorter-term assets compared to longer-term assets. The proposed rule would divide maturities into three categories for purposes of a covered company's RSF amount calculation: less than six months, six months or more but less than one year, and one year or more.

c. *Counterparty type*

A covered company may face pressure to roll over some portion of its assets in order to maintain its franchise value with customers and because a failure to roll over such assets could be perceived by market participants as an indicator of financial distress at the covered company. Typically, this risk is driven by the type of counterparty. For example, covered companies often consider their lending relationships with a wholesale, non-financial borrower to be important to maintain current business and generate additional business in the future. As a result, a covered company may have concerns about damaging future business prospects if it declines to roll over lending to such a customer for reasons other than a change in the financial condition of the borrower. More broadly, because market participants generally expect a covered company to roll over lending to wholesale, non-financial counterparties based on relationships, a covered company's failure to do so could be perceived as a sign of liquidity stress at the company, which could itself cause such a liquidity stress.

These concerns are less likely to be a factor with respect to financial counterparties because financial counterparties typically have a wider range of alternate funding sources already in place, face lower transaction costs associated with arranging alternate funding, and face less expectation of stable lending relationships with any single provider of credit. Therefore, market participants are less likely to assume the covered company is under financial distress if the covered company declines to roll over funding to a financial sector counterparty. In light of these business and reputational considerations, the proposed rule would require a covered company to more stably fund lending to non-financial counterparties than lending to financial counterparties, all else being equal.

d. *Market characteristics*

Assets that are traded in transparent, standardized markets with large numbers of participants and dedicated intermediaries tend to exhibit a higher degree of reliable liquidity. The proposed rule would, therefore, require less stable funding to support such assets than those traded in markets characterized by information asymmetry and relatively few participants. Depending on the asset class and the market, relevant measures of liquidity may include bid-ask spreads, market size, average trading volume, and price volatility. While no single metric is likely to provide for a complete assessment of market liquidity, multiple indicators taken together provide relevant information about the extent to which a liquid market exists for a particular asset class. For example, market data reviewed by the agencies show that securities that meet the criteria to qualify as HQLA typically trade with tighter bid-ask spreads than non-HQLA securities and in markets with significantly higher average daily trading volumes, both of which tend to indicate greater liquidity in the markets for HQLA securities.

e. *Encumbrance*

Whether and the degree to which an asset is encumbered will dictate the amount of stable funding the proposed rule would require a covered company to maintain to support the particular asset, as encumbered assets cannot be monetized during the period over which they are encumbered. For example, securities that a covered company has encumbered for a period of greater than one year in order to provide collateral for its longer-term borrowings are not available for the covered company to monetize in the shorter term. In general, the longer an asset is encumbered, the more stable funding the proposed rule would require. Encumbered assets generally cannot be monetized during the period in which they are encumbered. Thus, the proposed rule would require encumbered assets to be supported by stable funding depending on the tenor of the encumbrance. An asset that is encumbered for less than six months from the calculation date would be assigned the same RSF factor as would be assigned to the asset if it were unencumbered.

E. *Derivatives Transactions*

The proposed rule would calculate the stable funding requirement and available stable funding relating to a covered company's derivative transactions, as defined in the LCR rule. The calculation includes three components: (1) the current value of a covered company's derivatives assets and liabilities; (2) initial margin provided by a covered company pursuant to derivative transactions and assets contributed by a covered company to a central counterparty's ("CCP's") mutualized loss sharing arrangement in connection with cleared derivative transactions; and (3) potential future changes in the value of a covered company's derivatives portfolio. If the total derivatives asset amount exceeds the total derivatives liability amount, the covered company has an "NSFR derivatives asset amount," which would be assigned a 100 percent RSF factor. Conversely, if the total derivatives liability amount exceeds the total derivatives asset amount, the covered company has an "NSFR derivatives liability amount," which would not be considered stable funding and would be assigned a zero percent ASF factor. Additionally, the NSFR would apply a 100% RSF factor to 20% of the derivative liability exposures to account for potential future changes to market values and a 85% RSF factor to the fair value of assets contributed by a covered company to a CCP's mutualized loss sharing arrangement as these forms of collateral are assumed to be maintained at levels similar to current levels.

F. *Net Stable Funding Ratio Shortfall*

The agencies expect circumstances where a covered company has an NSFR shortfall to arise only rarely. The proposed rule would require a covered company to notify its appropriate

Federal banking agency of an NSFR shortfall or potential shortfall, that is, when a covered company's NSFR falls below 1.0.

Specifically, a covered company would be required to notify its appropriate Federal banking agency no later than 10 business days, or such other period as the appropriate Federal banking agency may otherwise require by written notice, following the date that any event has occurred that has caused or would cause the covered company's NSFR to fall below the minimum requirement. In addition, a covered company would be required to develop a plan for remediation in the event of an NSFR shortfall. The proposed rule would require a covered company to submit its remediation plan to its appropriate Federal banking agency no later than 10 business days, or such other period as the appropriate Federal banking agency may otherwise require by written notice, after: (i) the covered company's NSFR falls below, or is likely to fall below, the minimum requirement and the covered company has or should have notified the appropriate Federal banking agency, as required under the proposed rule; (ii) the covered company's required NSFR disclosures or other regulatory reports or disclosures indicate that its NSFR is below the minimum requirement; or (iii) the appropriate Federal banking agency notifies the covered company that it must submit a plan for NSFR remediation, and the agency provides a reason for requiring such a plan.

G. *Disclosure Requirements*

The disclosure requirements of the proposed rule would apply to covered companies that are bank holding companies and savings and loan holding companies and to holding companies subject to the FRB's proposed modified NSFR rule. The disclosure requirements of the proposed rule would not apply to depository institutions that are subject to the proposed rule.

The proposed rule would require public disclosures of a company's NSFR and its components to be made in a standardized tabular format ("NSFR disclosure template"). The proposed rule would also require the disclosures to contain sufficient discussion of certain qualitative features of a company's NSFR and its components to facilitate an understanding of the company's calculation and results. A company subject to the disclosure requirements must provide the public disclosures each calendar quarter in a direct and prominent manner on its public internet site or in a public financial report or other public regulatory report. Such disclosures would need to remain publicly available for at least five years from the date of the disclosure. Disclosure on a quarterly basis would provide market participants and other parties with information to help them assess the liquidity risk profiles of companies making the disclosures

III. Conclusion

Staff recommends that the Board approve for publication in the *Federal Register* the attached NPR, which would establish a quantitative net stable funding ratio for covered FDIC-supervised institutions. In addition to ensuring the covered bank's liquidity over the one year time horizon, the uniform NSFR requirement will provide the FDIC with periodic information regarding the funding structure of covered companies and discourage reliance on more volatile, short term funding. In this way, staff believes the NSFR will be an important tool for the FDIC with respect to its supervisory, deposit-insurance and resolution responsibilities.

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