Regulatory Capital and Liquidity Measures

March 2015
Agenda

• Regulatory Capital
  • A quick recap
    • Basel III implementation in the United States
    • Enhanced prudential standards
  • Proposed G-SIB buffer
  • Financial Stability Board’s TLAC proposal

• Regulatory Liquidity
  • Leverage ratio
  • Supplementary leverage ratio
  • Liquidity Coverage Ratio (LCR)
  • Enhanced prudential standards liquidity buffer requirement
  • Net Stable Funding Ratio (NSFR)
Regulatory Capital
Recap – Basel III Implementation

- Regulatory capital rules approved in July 2013
- Summary
  - Minimum common equity Tier 1: 4.5% RWA
  - Additional Tier 1: 1.5%
  - Tier 2: 2%
  - Total capital ratio: 8%
  - Capital conservation buffer: minimum common equity of 2.5% of RWA
  - Countercyclical buffer: up to 2.5% of common equity of RWA
  - G-SIB buffers (to be finalized)
Recap – Basel III Implementation (cont’d)

Capital Conservation Buffer ("CCB")

- Ratio of CET1 capital to risk-based assets of 2.5 percent (on top of each RBC ratio)
- A bank’s actual CCB will equal the lowest of the following three amounts (but not less than zero):
  - Bank’s CET1 ratio minus 4.5%
  - Bank’s Tier 1 RBC ratio minus 6%
  - Bank’s Total RBC ratio minus 8%
- Failure to meet buffer results in restrictions on payouts of capital distributions and discretionary bonus payments to executives
- Maximum amount of restricted payout equals eligible retained income* times a specified payout ratio. Payout ratio is a function of the amount of the bank’s capital conservation buffer capital

  *Most recent 4 quarters of net income, net of cap distributions and certain discretionary bonus payments
Recap – Basel III Implementation (cont’d)

Countercyclical Capital Buffer
- For Advanced Approaches banking organizations:
  - Not a concern for community banks
  - A macro-economic countercyclical capital buffer of up to 2.5 percent of CET1 capital to risk-weighted assets
  - Augments the capital conservation buffer
  - Applied upon a joint determination by federal banking agencies
  - Unrestricted payouts of capital and discretionary bonuses would require full satisfaction of countercyclical capital buffer as well as capital conservation buffer
### Recap – Basel III Implementation (cont’d)

<table>
<thead>
<tr>
<th>Type of ratio</th>
<th>Current</th>
<th>New</th>
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</thead>
<tbody>
<tr>
<td><strong>Minimum risk-based ratios</strong></td>
<td></td>
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<tr>
<td>CET1 risk-based</td>
<td>N/A</td>
<td>4.5%</td>
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<tr>
<td>Tier 1 risk-based*</td>
<td>4%</td>
<td>6%</td>
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<tr>
<td>Total risk-based</td>
<td>8%</td>
<td>8%</td>
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<tr>
<td>CET1 capital conservation buffer (risk-based)</td>
<td>N/A</td>
<td>+2.5%</td>
</tr>
<tr>
<td>CET1 countercyclical capital buffer (risk-based for Advanced Approaches banks)</td>
<td>N/A</td>
<td>+2.5%</td>
</tr>
<tr>
<td><strong>Minimum leverage ratios</strong></td>
<td></td>
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</tr>
<tr>
<td>Tier 1 leverage to average assets</td>
<td>3% / 4%</td>
<td>4%</td>
</tr>
<tr>
<td>Tier 1 supplementary leverage ratio for 8 largest banks</td>
<td>N/A</td>
<td>3% + 2%</td>
</tr>
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*Existing: at least 50% of qualifying total capital must be Tier 1; no such limit under new rule*
Recap – Basel III Implementation (cont’d)

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<tbody>
<tr>
<td>Common Equity Tier 1 Capital</td>
<td>4.000%</td>
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<tr>
<td>Tier 1 Capital Ratio</td>
<td>5.500%</td>
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<tr>
<td>Capital Conservation Buffer</td>
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<td>1.250%</td>
<td>1.875%</td>
<td>2.500%</td>
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<tr>
<td>Countercyclical Capital Buffer (maximum)</td>
<td>0.625%</td>
<td>1.250%</td>
<td>1.875%</td>
<td>2.500%</td>
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</tr>
<tr>
<td>Total Capital Required</td>
<td>8.000%</td>
<td>8.000%</td>
<td>9.250%</td>
<td>10.500%</td>
<td>11.750%</td>
<td>13.000%</td>
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<tr>
<td>Leverage Ratio</td>
<td>4.000%</td>
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<td>4.000%</td>
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<tr>
<td>Supplementary Leverage Ratio</td>
<td>3.000%</td>
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* Banks must begin reporting this supplementary leverage ratio in January 2015

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<td>4.000%</td>
<td>4.000%</td>
<td>4.000%</td>
<td>4.000%</td>
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Source: Fed, FDIC, J.P. Morgan
Enhanced Prudential Standards

- February 2014: Fed adopted Final Rule for Enhanced Prudential Standards under Sections 165 and 166 of Dodd-Frank; compliance period began January 1, 2015 for larger banks
- Designed to prevent/mitigate risks to U.S. financial stability that could arise from the material financial distress or failure, or ongoing activities of, large, interconnected financial institutions
- Enhanced Prudential Standards increase in stringency based on the systemic footprint and risk characteristics of the financial institution: (1) capital, (2) risk management, (3) liquidity, (4) stress testing, and (5) debt-to-equity limits
Enhanced Prudential Standards (cont’d)

• Final Rule incorporates previously issued capital plan and stress test requirements
  • Capital Plan Rule (2011) imposes enhanced, risk-based and leverage capital requirements on $50BB BHCs and requires submission of annual capital plan that demonstrates ability to maintain capital above minimum ratios under baseline and stressed conditions
  • DFA Rules (2012) require $50BB BHCs to conduct periodic supervisory and company-run stress tests
  • DFA Rules (2012) require $10BB BHCs, SHLCs and banks to conduct annual company-run stress tests
## Enhanced Prudential Standards (cont’d)

<table>
<thead>
<tr>
<th>Size</th>
<th>Requirements</th>
<th>Subpart of Final Rule</th>
</tr>
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<tbody>
<tr>
<td>$10BB BHCs and SLHCs and banks with more than $10BB in total consolidated assets</td>
<td>Company-run stress tests</td>
<td>Subpart B</td>
</tr>
<tr>
<td>$10BB BHCs that are publicly traded</td>
<td>Risk committee</td>
<td>Subpart C</td>
</tr>
<tr>
<td>$50BB BHCs</td>
<td>Risk-based and leverage capital</td>
<td>Subpart D</td>
</tr>
<tr>
<td></td>
<td>Risk management</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Risk committee</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Liquidity risk-management, stress-testing and buffers</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Supervisory stress tests</td>
<td>Subpart E</td>
</tr>
<tr>
<td></td>
<td>Company-run stress tests</td>
<td>Subpart F</td>
</tr>
<tr>
<td></td>
<td>Debt-to-equity limits (upon grave threat determination)</td>
<td>Subpart U</td>
</tr>
<tr>
<td>NBFCs</td>
<td>Supervisory stress tests</td>
<td>Subpart E</td>
</tr>
<tr>
<td></td>
<td>Company-run stress tests</td>
<td>Subpart F</td>
</tr>
</tbody>
</table>
G-SIB Surcharge Proposal

- Proposed in December 2014; comment period was scheduled to close in February, but was extended
- Implementation is scheduled to be phased in from January 2018 to 2019
- The proposal contemplates the imposition of a surcharge for U.S. G-SIBs (currently, eight banks)
  - Bank would calculate its systemic importance through application of two methods
  - Using the higher of the two results, bank would then determine the applicable surcharge
- Surcharge augments the capital conservation buffer. The capital conservation buffer is divided into quartiles, each associated with increasingly restrictive limitations on a bank’s capital distributions and discretionary bonus payments
G-SIB Surcharge Proposal (cont’d)

- The U.S. approach differs from the FSB/Basel approach by introducing a short-term wholesale funding component into Method 2.
- Two methods in the proposed rule:
  - **Method 1**: Surcharge based on sum of bank’s systemic indicator score (reflects size, interconnectedness, cross-border activity, substitutability, complexity)

<table>
<thead>
<tr>
<th>Method 1 Score (bp)</th>
<th>Surcharge (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>&lt;130</td>
<td>0</td>
</tr>
<tr>
<td>130 – 229</td>
<td>1.0</td>
</tr>
<tr>
<td>230 – 329</td>
<td>1.5</td>
</tr>
<tr>
<td>330 – 429</td>
<td>2.0</td>
</tr>
<tr>
<td>430 – 529</td>
<td>2.5</td>
</tr>
<tr>
<td>530 – 629</td>
<td>3.5</td>
</tr>
<tr>
<td>&gt;630</td>
<td>3.5 plus 1.0% for every 100 bp increase in score</td>
</tr>
</tbody>
</table>
G-SIB Surcharge Proposal (cont’d)

- **Method 2**: Surcharge based on systemic indicator scores, as detailed above, as well as a measure of the bank’s use of short-term wholesale funding, but excluding systemic indicator score for substitutability.

<table>
<thead>
<tr>
<th>Method 2 Score (bp)</th>
<th>Surcharge (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>&lt;130</td>
<td>0</td>
</tr>
<tr>
<td>130 – 229</td>
<td>1.0</td>
</tr>
<tr>
<td>230 – 329</td>
<td>1.5</td>
</tr>
<tr>
<td>330 – 429</td>
<td>2.0</td>
</tr>
<tr>
<td>430 – 529</td>
<td>2.5</td>
</tr>
<tr>
<td>530 – 629</td>
<td>3.0</td>
</tr>
<tr>
<td>630 – 729</td>
<td>3.5</td>
</tr>
<tr>
<td>730 – 829</td>
<td>4.0</td>
</tr>
<tr>
<td>830 – 929</td>
<td>4.5</td>
</tr>
<tr>
<td>930 – 1029</td>
<td>5.0</td>
</tr>
<tr>
<td>1030 – 1129</td>
<td>5.5</td>
</tr>
<tr>
<td>&gt;1130</td>
<td>5.5% plus 0.5% for every 100 bp increase in score</td>
</tr>
</tbody>
</table>
G-SIB Surcharge Proposal (cont’d)

- Method 2’s short-term wholesale funding (STWF) score is intended to determine for the bank, on a consolidated basis, the amount of its short-term wholesale funding sources with a remaining maturity of less than one year for each business day of the preceding calendar year.
G-SIB Surcharge Proposal (cont’d)

- Basel approach caps the amount of the G-SIB surcharge at 3.5%; however, under the US proposal, the surcharge could be up to 5.5% or greater

<table>
<thead>
<tr>
<th>Bank Score</th>
<th>530-529</th>
<th>430-529</th>
<th>330-429</th>
<th>230-329</th>
<th>130-229</th>
</tr>
</thead>
<tbody>
<tr>
<td>G-SIB Bucket</td>
<td>Bucket 5 (+3.5% CET 1)</td>
<td>Bucket 4 (+2.5% CET 1)</td>
<td>Bucket 3 (+2.0% CET 1)</td>
<td>Bucket 2 (+1.5% CET 1)</td>
<td>Bucket 1 (+1.0% CET 1)</td>
</tr>
</tbody>
</table>
Total Loss Absorbing Capital ("TLAC")

• Financial Stability Board Proposal for Comment issued in November 2014; comment period closed in February 2015
• Intended to be effective by January 2019
• Designed to facilitate orderly resolution of G-SIBs
  • Includes 8 US banks
• Minimum total loss absorbing capital of 16-20% of risk weighted assets excluding buffers
  • Tier 1 and Tier 2 Capital
  • Other eligible TLAC that is not regulatory capital
• Minimum of a 6% leverage ratio: ratio of TLAC to total leverage exposure must equal at least 2 times bank’s leverage ratio
• Additional TLAC may be required for individual G-SIBs based on risk factors
TLAC Term Sheet

TLAC Eligible Securities:

- Issued and maintained by resolution entities
- Unsecured
- Remaining maturity of at least one year

- **Excludes**
  - Insured deposits
  - Any liability callable on demand without supervisory approval
  - Liabilities funded by the issuer or a related party
  - Liabilities arising from derivatives or debt instruments with derivative-linked features—e.g., structured notes
  - Non-contractual liabilities, such as tax liabilities
  - Preferred liabilities
  - Other liabilities that cannot be written down or converted to equity by resolution authorities
TLAC Term Sheet (cont’d)

• Junior to excluded liabilities on the balance sheet of the resolution entity
• No set off
• No redemption without supervisory approval
• Material subsidiaries in jurisdictions outside of bank’s home country must have “Internal TLAC”
  • Each material subsidiary must have 75-90% of the amount required of the resolution entity
TLAC Term Sheet (cont’d)
Regulating Liquidity
Leverage Ratio

• Basel leverage ratio was finalized in January 2014; public disclosure of the leverage ratio was required in January 2015
• Final calibrations and adjustments expected by 2017, with implementation required in 2 January 2018
• Requires a bank hold a minimum of 3% of Tier 1 capital against their exposures (Exposure Measure)
• Exposure Measure = On-Balance Exposures + Derivatives Exposures + Securities Financing Exposures + Other Off-Balance Sheet Items
Leverage Ratio (cont’d)

- **On-balance sheet exposures** = on-balance sheet items (excluding derivatives and SFTs, but including collateral) – Tier 1 capital
- **Derivatives exposures** = replacement cost for all derivative transactions + add-on amounts for potential future exposures for all derivatives + gross-up of derivatives collateral less eligible assets received as cash variation margin + notionals of written credit derivatives, less eligible offsets and deductions – exposures related to the qualifying central counterparty leg of client-cleared derivatives
- **SFT exposures** = gross SFT assets, less eligible netting of SFT assets + counterparty credit risk exposure for SFT assets + agent transaction exposures
- **Other Off-Balance Sheet Items** = gross off-balance sheet exposures adjusted for drawdown assumptions
Supplementary Leverage Ratio

• Finalized in September 2014; reporting began January 2015; compliance by January 2018
• Additional capital requirement for bank holding companies with total consolidated assets of $700 billion or greater and their insured depository institution subsidiaries
• Based on total leverage exposure that includes selected off-balance sheet exposures
• 5% with 2 % leverage buffer for the bank holding company
• 6% for insured depository institution to be considered well capitalized.
• Tier 1 capital is to be calculated as of the last day of each reporting quarter.
• The total leverage exposure is to be calculated as the daily average of each reporting quarter for on-balance assets and the month-end average of each reporting quarter for off-balance sheet assets.
Supplementary Leverage Ratio (cont’d)

- May affect repo, securities financing transactions and collateral transformation transactions, derivatives
  - CFTC Chair Massad has requested further consideration of the effect of the leverage ratio on the derivatives market
Liquidity Coverage Ratio (LCR)

Final Rule adopted September 2014

• Covered organizations must maintain high quality liquid assets (HQLA) equal to estimated net cash outflows over a 30-day stressed liquidity period
• Applies to Advanced Approaches organizations, and any subsidiary bank with $10BB+
• Simpler modified version applies to others ("modified companies") with $50BB+ and that do not have significant commercial or insurance operations
• Effective date: covered companies must calculate their LCRs at each month-end beginning January 1, 2015 but "modified companies" begin on January 1, 2016.
**LCR (cont’d)**

- **Full LCR** applies to: advanced approaches banks ($250b in total consolidated assets or $10b or greater in on-balance sheet foreign exposures); other institutions made subject to LCR
- **LCR Light** (Modified LCR): depository institutions with $50b or less in total consolidated assets that are not: grandfathered SLHCs deriving 50% or greater of total assets or revenues from activities not financial in nature; insurance underwriting companies; or holding 25% or greater of total assets in insurance underwriting subsidiaries. Monthly (instead of daily) LCR calculations.
- Final rule does not apply to FBOs.
LCR (cont’d)

- LCR requires HQLA stock to be at least 100% of its total net cash outflows over a 30-day standardized liquidity stress scenario, plus a maturity mismatch add-on that includes only certain inflows/outflows likely to cause a maturity mismatch.

\[
\frac{\text{High-Quality Liquid Assets}}{\text{Total Net Cash Outflows}} \geq 100\%
\]

- HQLAs are categorized as Level 1, Level 2A and Level 2B.
  - No limit on Level 1 assets
  - Level 2 assets are capped at 40% of HQLAs; Level 2B assets are capped at 15% of total HQLAs.
LCR (cont’d)

• Level 1 assets are not subject to haircuts. These include: excess reserves held at Fed, US Treasuries, securities issued or guaranteed by full faith and credit of US government, etc.

• Level 2A assets are subject to a 15% haircut. These include: Agency securities, claims on or guaranteed by a sovereign entity or multilateral development bank

• Level 2B assets are subject to a 50% haircut. These include: certain corporate debt securities issued by non-financial companies; certain publicly traded equities of non-financial companies included in Russell 1000 Index or foreign equivalent
LCR-Out Flows and Inflows

- 30-day measurement period
- Maturity
  - Earliest possible for outflows
  - Latest possible for inflows
- Flows specified by transaction type
- Inflows capped at 75% of outflows
Modified LCR

- Depository institution holding companies with total consolidated assets of $50 billion but that do not meet threshold for standard LCR
- Total net cash out flow discounted to 70%
- Meet ratio on last day of calendar month
LCR

• Observations:
  • As with other aspects of Basel III, the banking agencies in the United States adopted a version of the LCR which is more burdensome than the Basel LCR
    • U.S. compliance schedule is more rigorous
    • Securities like municipal securities, covered bonds and RMBS are excluded form HQLAs in the U.S.
    • U.S. version includes a mismatch add-on
    • U.S. version of HQLA does not incorporate use of credit ratings
  • Banks will have to consider whether to discontinue certain business lines, which may be more “expensive,” such as prime brokerage
  • Definition of HQLA may affect availability/supply of Treasuries, Agency securities, etc.
  • Of course, these securities are low-yielding
  • Banks will look to extend liabilities past the 30-day mark
Enhanced Prudential Standards

- The final rule sets out a qualitative liquidity framework for large bank holding companies
  - Requirement that Board approve institution’s liquidity risk tolerance at least annually
  - Review at least semi-annually compliance with established liquidity risk tolerance
  - Approve and periodically review liquidity risk management strategies, policies and procedures established by senior management
- The final rule requires internal liquidity stress testing monthly
- A large BHC also must maintain a liquidity buffer of unencumbered highly liquid assets sufficient to meet the projected net stressed cash flow need over the 30-day planning horizon of a liquidity stress test
- Important to note LCR is based on prescribed calculations while EPA Liquidity Buffer Requirement is based on internal models
Net Stable Funding Ratio

- Basel Committee on Bank Supervision
  - No proposal from US Regulators yet
- Longer term counterpart to the liquidity coverage ratio
- One-year measurement period
- Objective: to reduce maturity mismatches between assets and liabilities and thereby reduce funding and rollover risk
- Bank’s Available Stable Funding ÷ Required Stable Funding ≥100%
Available Stable Funding

- Available Stable Funding: most stable sources of funding, expected to be reliable over a one-year time horizon
- A multiplier is applied to designated sources of funding, the ASF Factor—for example:
  - 100%--Capital and liabilities with maturity is excess of 1 year
  - 95%--stable deposits from retail and small business customers with maturities of less than 1 year
  - 50%--other funding with a maturity of less than one year from non financial customers, operational deposits, funding from sovereigns and public sector entities, and other funding with maturities of six months to one year from financial institutions
  - 0%--Other liabilities including funding from financial institutions with a maturity of less than six months, other liabilities without a stated maturity, net derivative liabilities, and trade date payables for financial transactions
Required Stable Funding

• Required Stable Funding: “grades” assets in terms of the proportion of stable funding required to support them and assigns a factor (RSF factor)—for example:

  • 0%--Cash, central bank reserves, claims on central banks with a maturity of less than 6 months, trade date receivables from financial transactions
  • 5%--Unencumbered Level 1 assets
  • 10%--Unencumbered loans to financial institutions secured by Level 1 assets and with rehypotecation rights
  • 15%--Unencumbered Level 2A assets and other unencumbered loans to financial institutions with maturities of less than six months
  • 50%--Unencumbered Level 2B assets, HQLAs that are encumbered for between six months and one year, loans to financial institutions an central banks with a maturity of six months to one year, operational deposits, and non-HQLAs with a maturity of less than one year
Required Stable Funding (cont’d)

- 65%—unencumbered residential mortgages and other loans, with a maturity of one year or more and with a 35% or lower risk weight
- 85%—initial margin for derivative contracts and assets provided to central counterparty default funds, unencumbered loans with a risk weight of greater than 35% with maturities, non-HQLA securities with a maturity of one year or more of one year or more, exchange traded equities that are not HQLAs, and physical traded commodities
- 100% assets that are encumbered for one year or more, net derivative assets, other assets with a maturity of one year or more, non exchange traded equities, fixed assets, deductions from regulatory capital retained interest, insurance assets subsidiary interests, defaulted securities, negative replacement amounts for derivatives
Capital structure

• Traditional equity/debt divide is less clear in certain respects
  • Historically, “hybrid” securities, like trust preferred securities or REIT preferred, blurred certain of the distinctions between equity and debt as a result of their subordination and deferral features
  • Now, at least for European banks, there may be a lack of transparency resulting from the issuance of a variety of Additional Tier 1 (AT1) capital securities, such as “high trigger” and “low trigger” securities (“contingent capital”)
  • European banks already are subject to “bail in” tool in respect of most unsecured debt obligations and going forward also will be required to have a specified amount of “MREL” under the BRRD
  • In addition, now banks (US and European) will need to have a certain amount of TLAC—where does TLAC fall in the equity/debt continuum?
  • How will investors price all of these securities?
  • Who will buy these securities?
    • In the UK, the FCA has banned the sale of contingent capital securities to retail investors
    • The liquidity measures also serve to deter banks from buying/holding securities issued by other banks
Tenor and call features

• If one were to consider only a single liquidity measure at once, for example, only the LCR, that might suggest that:
  • A bank will want to have the ability to extend the maturities of its short-term obligations past the 30-day cut-off
  • Moreover, if one were to layer on to the LCR analysis, the G-SIB STWF Factor, a bank would be even more focused on minimizing its reliance on short-term funding

• For purposes of both the LCR and the NSFR, a bank must assume that any security with a call feature gets called; this may affect structuring preferences
Business lines

• Application of the liquidity measures are likely to impact:
  • Cross holdings in other financial institutions
  • Repo market
  • Derivatives market
  • Prime broking
  • Long-term lending