Treatment of Securitizations under LCR/NSFR

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Presenters:

Peter J. Green, Partner, Morrison & Foerster LLP
Jeremy C. Jennings-Mares, Partner, Morrison & Foerster LLP
Jerry R. Marlatt, Senior Of Counsel, Morrison & Foerster LLP

1. Presentation

2. Morrison & Foerster LLP Client Alert:
   “LCR – The Fed Takes Tentative Step to Expand HQLAs”

3. Morrison & Foerster LLP User Guide:
   “Liquidity Coverage Ratio: A Quick Reference”

4. Morrison & Foerster LLP Client Alert:
   “From EMIR to Eternity?
   The EU Financial Regulatory Agenda into 2015 Beyond”

5. Morrison & Foerster LLP Client Alert:
   “A Closer Look at U.S. Credit Risk Retention Rules”

6. International Financial Law Review Article:
   “Tougher than Basel”
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Jerry Marlatt
Basel Treatment of Securitisations

• In December 2014, Basel published its revised securitisation framework. The revised framework aims to address certain shortcomings in the Basel II securitisation framework and to strengthen capital standards for securitisation exposures held in the banking book, and will come into effect in January 2018.

• Certain weaknesses were perceived in the Basel II securitisation framework during the financial crisis, such as:
  ➢ mechanistic reliance on external ratings;
  ➢ excessively low risk weights for highly-rated securitisation exposures;
  ➢ excessively high risk weights for low-rated senior securitisation exposures;
  ➢ cliff effects; and
  ➢ insufficient risk sensitivity of framework.
Basel Treatment of Securitisations (cont.)

- The revised framework is now intended to be more risk-sensitive, more prudent in terms of its calibration, to be broadly consistent with the underlying framework for credit risk and to be as simple as possible. In addition it aims to incentivise improved risk management by assigning capital charges using the best and most diverse information available to banks.
- Gain on sale to be deducted fully from capital.
- Non-compliant securitisation positions to be 1250% risk-weighted.
Basel Treatment of Securitisations - Hierarchy

• Basel II framework consists of two hierarchies:
  ➢ standardised approach (SA) for banks that apply the SA credit risk framework for the asset class comprising the underlying pool of securitised exposures;
  ➢ internal ratings based approach (IRB) for banks that apply IRB approach to credit risk framework for the relevant underlying asset class.

• Basel III framework revises the hierarchies to reduce reliance on external ratings, simplify the hierarchy and limit the number of approaches.

• Revised hierarchy:
  ➢ securitisation internal ratings-based approach (SEC-IRBA); then
  ➢ securitisation external ratings-based approach (SEC-ERBA); then
  ➢ securitisation standardised approach (SEC-SA).
• SEC-IRBA uses the Simplified Supervisory Formula Approach (SSFA) and uses $K_{IRB}$ information as a key input. $K_{IRB}$ is the capital charge for the underlying exposures using the IRB framework (either the advanced or foundation approaches). To use SEC-IRBA, a bank needs to have the same information as under the Basel II Supervisory Formula Approach, including a supervisory-approved IRB model for the type of underlying exposures and sufficient information to estimate $K_{IRB}$.

• If a bank cannot calculate $K_{IRB}$, it would have to use the SEC-ERBA (assuming this method has been implemented by its national regulator).

• If not, or if the tranche is unrated, the bank would have to use SEC-SA, using $K_{SA}$ as input. $K_{SA}$ is the capital charge for underlying exposures, using the Standardised Approach for credit risk.

• If none of the above can be used by a bank, the exposure would have a risk weight of 1250%.
Existing Basel II SFA gives rise to sharp cliff effects in marginal capital charges, partly due to maturity not being fully incorporated into the calculations. SEC-IRBA will incorporate tranche maturity as an additional driver of risk.

SEC-ERBA will consider additional risk drivers, such as:
- tranche thickness (in comparison with the entire securitisation) – not currently taken into account under Basel II RBA; and
- tranche maturity.

In summary:
- simpler hierarchy compared to Basel II;
- hierarchy the same whether bank is originator or investor – does not depend on the credit risk approach applied to underlying exposures, but to information available to the bank and type of analysis it can perform on a specific transaction;
- reduction of mechanistic reliance on external credit ratings; and
- capital requirements increased, though senior tranches backed by good pools can achieve 15%.
Basel III Capital Rules

• Basel III capital rules also will impact securitisations and the effect will be different in the EU and in the U.S.
• The capital rules are designed to require minimum capital (or equity) for the bank’s assets.
• As implemented in the U.S., the Basel III framework has three hierarchies – different hierarchies from the EU in order to eliminate the use of external ratings in U.S. regulations:
  ➢ Simplified Supervisory Formula Approach (SSFA) or Gross-up Approach;
  ➢ Internal Ratings-Based and Advanced Measurement Approach; and
  ➢ Market Risk Approach.
In the U.S., the general capital rule is that the ratio of qualifying tier 1 capital assets divided by total risk weighted assets must at least equal 8%.

\[
\frac{\text{Qualifying tier 1 capital assets}}{\text{Total risk weighted assets}} \geq 8\%
\]

- The amount of risk weighted assets is determined by multiplying the ‘exposure amount’ of each asset by a ‘risk weight’ (RW).
- The risk weight to be used is determined by applying one of the three hierarchies.
- There are many special rules for determining the ‘exposure amount’ for a securitisation exposure.
- The magnitude of the new capital requirements is imposing.
The hierarchy to be applied depends on the nature of the bank:

- Simplified Supervisory formula approach (SSFA) or gross-up approach is used to determine the risk weight for a securitisation exposure for banks with less than $250 billion of consolidated assets and less than $10 billion of on-balance sheet foreign exposures;
- the internal ratings-based and advanced measurement approach is used if a bank has $250 billion or more of consolidated assets or $10 billion or more of on-balance sheet foreign exposure; and
- the market risk approach is used for those banks with aggregate trading assets and trading liabilities equal to 10% or more of total assets at quarter end or $1 billion or more.
U.S. Capital Rules - Securitisations

• No capital is required for assets sold into a securitisation if:
  ➢ capital is held against any retained credit risk
  ➢ assets are not consolidated for GAAP
  ➢ credit risk of the assets is transferred
  ➢ securitised asset is not a line of credit and there is no early amortisation

• If conditions are not met, a bank must hold capital against all of the assets in the securitisation and deduct from common equity tier 1 capital any after tax gain-on-sale.

• For any retained credit risk, 1250% risk weight is applied if a bank fails to demonstrate a comprehensive understanding of the retained credit risk.

• Gain-on-sale – Deduct from common equity tier 1 capital the amount of any after tax gain-on-sale.
U.S. Capital Rules – Securitisations (cont.)

• Mortgage servicing assets (MSAs) are risk weighted at 250%.
• Derivative exposure to securitisations – increasing capital with longer maturity:
  ➢ OTC derivatives; and
  ➢ CCP cleared derivatives.
• Securitisation derivatives are usually OTC since they have unusual features such as non-recourse and declining notional balance.
• For a securitisation exposure that is a derivative:
  ➢ exposure amount is the sum of the current exposure amount and the potential future exposure (PFE) amount
    ▪ current exposure amount = greater of zero or mark to fair value
    ▪ potential future exposure amount = notional amount x CCF, which depends on the maturity of the swap; for a swap with a one to five year maturity
      o interest rate swap – ½% of notional balance
      o exchange rate swap – 5% of notional balance
• Securitisation exposure:
  ➢ on-balance sheet – exposure equal to carrying value;
  ➢ off-balance sheet – exposure equal to notional amount; increases with subordination;
  ➢ capital required will not exceed 100% of the amount of the exposure, i.e., a 1250% risk weight;
  ➢ 1250% risk weight is applied to any portion of a credit enhancing interest only strip that does not constitute an after tax gain-on-sale;
  ➢ non-credit enhancing interest only strip, will never have less than 100% risk weight;
  ➢ under Gross-up Approach: AAA class is risk weighted same as underlying collateral – why? No benefit of support; and
  ➢ subordinated tranches – hold capital against the tranche held and all tranches supported by the tranche held.
Basel Treatment of Securitisations – Liquidity Treatment

• Basel III introduced a liquidity cover ratio (“LCR”) which is intended to measure whether banks hold an adequate level of unencumbered, high quality liquid assets to meet predicted net cash out flows under a stress scenario that lasts for 30 days. Once fully implemented, a bank would be expected to maintain an LCR of at least 100% i.e. it would hold stocks of liquid assets sufficient to meet all net cash outflows under a 30 day stress scenario.

• In Europe, the Basel III LCR has been implemented through the Capital Requirements Regulation and the LCR is being phased in over four years, starting at 60% from 1 October 2015 and rising to 100% as from 1 January 2018 (although the European Commission has power to adopt a delegated act delaying the full 100% application of the ratio until 1 January 2019).
In the original proposals by the EBA, only certain residential mortgage backed securities were to be treated as liquid assets for the purpose of the LCR. However, the final regulation adopted in October 2014 now broadens the scope of securitisation assets that can be considered liquid for this purpose.

The final regulation currently applies only to banks and the European Commission is required to report by 31 December 2015 on whether and how the LCR should apply to investment firms that are subject to the CRR.
EU LCR Provisions

- Liquid assets are divided into level 1 assets (assets of extremely high liquidity and credit quality) and level 2 assets (assets of high liquidity and credit quality).
- Level 2 assets are further subdivided into level 2A and 2B assets.
- Covered bonds of extremely high quality are included within level 1 assets (up to 70% of level 1 assets) and are subject to a minimum haircut of at least 7% and lesser quality covered bonds may be included in level 2A assets, with a haircut of at least 15%, or in level 2B assets, with a haircut of at least 30%.
- Certain asset backed securities that meet the requirements in article 13 of the delegated regulation can be included as level 2B assets (which may compose up to 15% of the overall liquidity buffer).
- At least 60% of the LCR buffer must consist of level 1 assets.
Asset-backed securities as liquid assets under EU LCR

- Asset-backed securities need to meet the following requirements for eligibility for level 2B:
  - the securitisation position has been assigned a credit assessment of at least credit quality step 1;
  - the position is the most senior tranche of the securitisation;
  - the underlying exposures must have been acquired by the issuer in a manner that is enforceable against any third party and beyond the reach of the originator, sponsor, or original lender and its creditors, including in the event of insolvency;
  - the transfer of the underlying exposures to the issuer may not be subject to any severe claw-back provisions in the jurisdiction where the seller is incorporated;
  - the underlying exposures are governed by a servicing agreement which includes continuity provisions which ensure that a default or insolvency of the servicer does not result in termination of servicing;
  - the documentation includes continuity provisions that ensure the replacement of derivatives counterparties and liquidity providers upon their default or insolvency;
Asset-backed securities as liquid assets under EU LCR (cont.)

- the securitisation is backed by a pool of homogeneous underlying exposures, all belonging to only 1 of the following sub categories:
  - residential loans secured with a first ranking mortgage, granted to individuals for acquisition of their main residence (subject to the loans in the pool meeting certain loan to value requirements and the national law of the member states where the loans were originated providing for a loan-to-income limit on the amount that an obligor may borrow in a residential loan);
  - residential loans fully guaranteed by an eligible protection provider and meeting certain collateralisation requirements and average loan to value requirements;
  - commercial loans, leases and credit facilities to EU undertakings to finance capital expenditures or business operations other than commercial real estate, where at least 80% of the borrowers in the pool are small and medium sized enterprises;
  - auto loans and leases to EU borrowers or lessees; and
  - loans and credit facilities to EU individuals for personal, family or household consumption purposes.

- the position is not in a resecuritisation or synthetic securitisation;

- the underlying exposures do not include:
  - transferable financial instruments or derivatives;
  - exposures to credit-impaired obligors; or
  - exposures in default within the meaning of article 178 (1) of CRR.
Asset-backed securities as liquid assets under EU LCR (cont.)

• The repayment of the securitisation positions must not depend predominantly on the sale of assets securing the underlying exposures.

• Where no revolving period is in effect, principal receipts from the underlying exposures must be passed to the holders of the securitisation positions on each payment date via sequential amortisation of the positions with no substantial amount of cash being trapped in the issuer.

• During any revolving period, the documentation must provide for appropriate early amortisation events including a deterioration in credit quality of the underlying exposures, a failure to generate sufficient new underlying exposures of a similar credit quality, and the occurrence of an insolvency related event with regard to the originator or servicer. At the time of issuance of the securitisation, the borrowers must generally have made at least 1 payment.

• In the case of residential loans, the pool of loans must not include any “self certified” loans.
Asset-backed securities as liquid assets under EU LCR (cont.)

• In the case of underlying exposures that are residential loans, the assessment of the borrower’s creditworthiness must meet the requirements in article 18 of the Mortgage Credit Directive.

• Where the underlying exposures are auto loans and leases and consumer loans and credit facilities the assessment of the borrower’s creditworthiness must meet the requirements set out in article 8 of the Consumer Credit Directive.

• Where the originator sponsor or original lender of the securitisation is established in the EU, it must comply with the requirements set out in part 5 of CRR (in relation to due diligence and disclosure of information).

• For originators, sponsors and original lenders established outside the EU, comprehensive loan level data must be made available to existing and potential investors and regulators, both at issuance and on a regular periodic basis.

• The exposures must not have been originated by the institution that is required to comply with the LCR or its affiliates.
Asset-backed securities as liquid assets under EU LCR (cont.)

- The issue size of the tranche must be at least EUR100 million or equivalent.
- The remaining weighted average life of the tranche shall be 5 years or less.
- The originator of the exposures must be a credit institution or investment firm subject to CRR, or an undertaking whose principal activity is to pursue lending or other financial activities specified in certain paragraphs of annex 1 to the CRD 4 directive.
- Securitisations of residential loans and auto loans and leases are subject to a minimum 25% haircut and securitisations of commercial loans, leases and credit facilities and individual loans and credit facilities are subject to a minimum haircut of 35%.
Commitments to SSPEs under the CRR

• Relates to liquidity facilities provided to a securitisation special purpose entity (SSPE):
  ➢ for the purpose of enabling the SSPE to purchase assets other than securities from clients that are not financial customers.

• Committed amount is multiplied by 10% for the purpose of the LCR to the extent such amount exceeds the amount of assets currently purchased from clients and where the maximum amount that can be drawn is contractually limited to the amount of assets currently purchased.
EU Draft Securitisation Regulation

• On 30 September 2015 the European Commission published drafts of a proposed Securitisation Regulation and CRR Amendment Regulation containing provisions relating to:

  ➢ harmonisation of rules relating to due diligence, risk retention and disclosure for all securitisations;
  ➢ creating a European framework for simple, transparent and standardised (STS) securitisation transactions and amending the CRR to provide a more favourable capital treatment for STS securitisations; and
  ➢ consequential amendments to other EU legislation including the UCITS IV Directive, the Solvency II Directive and the AIFMD.

• Rules relating to criteria for STS securitisations are very similar to those relating to asset-backed securities that qualify as liquid assets under the Delegated Regulation setting out the LCR rules in the EU (see above).

• European Commission has stated that it will amend this Delegated Regulation to align the LCR rules with the Securitisation Regulation and the CRR Amendment Regulation once the forms of the new proposed Regulations are finalised.
U.S. Liquidity Coverage Ratio

• Adopted by FRB, OCC and FDIC in September 2014.
• Generally follows Basel III, but stricter in several respects.
• Effective Jan. 1, 2015 and fully phased in Jan. 1, 2017
• Establishes liquidity requirements for:
  ➢ large internationally active banking holding companies
    • total consolidated assets of $250 billion or more; or
    • $10 billion or more of on-balance sheet foreign exposures
  ➢ lesser requirements for $50 billion or more in consolidated assets

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

• Daily calculation.
• LCR Rule does not apply to FBOs.
U.S. LCR (cont.)

- LCR requires total HQLA to be at least 100% of the bank’s 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

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

- As in the EU, HQLA are categorized as Level 1, Level 2A and Level 2B
  - No limit on Level 1 assets
  - Level 2 assets are capped at 40% of total HQLA assets;
  - Level 2B assets are capped at 15% of total HQLA assets
U.S. High Quality Liquid Assets

• The qualifying amount for HQLA assets are haircut, depending on the level of the asset:
  ➢ Level 1 – 100% of fair value
  ➢ Level 2A – 85% of fair value
  ➢ Level 2B – 50% of fair value

• Qualifying assets under U.S. LCR are considerably more restrictive than under EU LCR

• No financial sector entity obligations:
  ➢ regulated financial companies, investment companies, non-regulated funds, pension funds, investment advisers, or consolidated subsidiaries; and
  ➢ no covered bonds.

• No ABS, no RMBS, no municipal securities
HQLA in the U.S.

- **HQLA** –
  - **Level 1:**
    - Not subject to haircuts;
    - Reserve bank balances;
    - U.S. government obligations or guarantees;
    - Foreign sovereign, BIS, IMF, ECB, EU, or multilateral bank if 0% RW and liquid and readily marketable; and
    - Certain foreign sovereigns not 0% RW.
  - **Level 2A – 15% haircut:**
    - GSE securities investment grade and senior to preferred stock; and
    - Other foreign sovereigns if 20% RW and meet stress tests.
  - **Level 2B – 50% haircut provided stress tests are met:**
    - Corporate debt investment grade; and
    - Corporate stock.
LCR in the US – Outflows and Inflows

- 30 day measurement period.
- Maturity:
  - earliest possible date for outflows; and
  - latest possible date for inflows.
- Flows specified by transaction type.
- Inflows capped at 75% of outflows.
LCR in the US – SPE Commitments

- Specific rules relating to SPES – a bank’s commitment outflow includes:
  - 10/30% of the undrawn amount of all committed credit/liquidity facilities extended to a wholesale customer or counterparty that is not a financial sector entity or a consolidated subsidiary thereof (will include many SPEs that are consolidated subsidiaries) that does not issue commercial paper or securities;
  - 40/100% of the undrawn amount of all committed credit/liquidity facilities extended to a financial sector entity or a consolidated subsidiary thereof (including SPEs that are consolidated subsidiaries) that does not issue commercial paper or securities;
  - 100% of the undrawn amount of all committed and liquidity facilities extended to an SPE that issues or has issued commercial paper or securities (other than equity securities issued to a company of which the SPE is a consolidated subsidiary) to finance its purchases or operations; and
  - 100% of the undrawn amount of all other committed credit or liquidity facilities.
• For a bank sponsored structured transaction:
  - Not consolidated under GAAP, the greater of
    - 100% of all issuer obligations maturing in 30 days plus all issuer commitments to
      purchase assets in such 30 day period; or
    - the maximum contractual amount required to be provided to the issuer through a funding
      agreement in such 30 day period.
  - Consolidated under GAAP
    - 0% of funds the bank must pay secured by Level 1 assets
    - 15% of funds the bank must pay secured by Level 2A assets
    - 25% of funds the bank must pay to sovereigns or 20% GSEs to the extent not secured
      by Level 1 or Level 2A assets
    - 50% of funds the bank must pay secured by Level 2B assets
    - 100% of all other funds the bank must pay
Modified LCR in the US

- Depositary institution holding companies with total consolidated assets of $50 billion but that do not meet threshold for standard LCR.
- Total net cash outflow discounted to 70%.
- Meet ratio on last day of calendar month.
U.S. LCR Observations

• 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, ABS and RMBS are excluded from 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
  ➢ HQLA requirements for securitisation exposures may affect issuance levels
  ➢ 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
### EU:US LCR Comparison

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<th>Level</th>
<th>European Union</th>
<th>U.S.</th>
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<tbody>
<tr>
<td>HQLA</td>
<td>No absolute restrictions on financial sector assets</td>
<td>No financial sector entity assets permitted</td>
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<tr>
<td>Level 1</td>
<td>EU member state central banks/sovereigns Non-EU central bank/sovereigns 0% RW</td>
<td>US government Sovereign, BIS, IMF, ECB, EC or multilateral development bank if 0% RW</td>
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<td>Very high quality EU covered bonds (10% RW)</td>
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<td>Level 2A</td>
<td>EU Covered bonds – 20 % RW</td>
<td>85% of fair value - GSE obligations</td>
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<td>Non-Eu Covered bonds – 10% RW</td>
<td>Sovereign 20% RW</td>
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<td>Sovereigns/public sector 20% RW</td>
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<td>High Quality corporate bonds</td>
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<td>40 % cap</td>
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<td>Level 2B</td>
<td>Qualifying ABS</td>
<td>50% of fair value – Corporate debt</td>
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<td>Certain corporate debt/shares</td>
<td>Corporate stock</td>
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<td>Certain other EU covered bonds</td>
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<td>15 % cap</td>
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<td>15% cap</td>
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<td></td>
<td>15% cap</td>
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Basel Treatment of Securitisations – Net Stable Funding

- Basel III also introduced a net stable funding ratio ("NSFR") which is intended to reduce funding risk over a longer time period by requiring banks to fund their activities with sufficiently stable sources of funding.
- The NSFR requires that the ratio of Available Stable Funding to Required Stable Funding must be at least 100%.
- Basel III provides for this to become a minimum standard by 1 January 2018.
Net Stable Funding in the EU

• In the EU, banks currently have a general (unspecific) requirement under Section 413 of the Capital Requirements Regulation to ensure their long term obligations are “adequately met with a diversity of stable funding instruments under both normal and stressed conditions”.

• However, by 31 December 2015, the European Banking Authority (“EBA”) must report to the European Commission on whether and how it would be appropriate to ensure that institutions use stable sources of funding, as well as the methodologies for determining the amounts of Available Stable Funding and Required Stable Funding.

• By 31 December 2016, the European Commission must have submitted draft legislation to the European Parliament and the Council, or decided not to implement a binding Net Stable Funding Ratio.

• There has been no proposal from U.S. regulators yet.
Net Stable Funding and Securitisations

• How will the NSFR affect securitisations?
• A bank investing in a securitisation will be required to demonstrate a certain amount of stable funding in connection with the asset (the securitisation holding) it has invested in.
• Also, a bank originator will be required to demonstrate a certain amount of stable funding in connection with the assets retained by it (whether the securitisation bonds or the underlying assets) pursuant to the applicable risk retention requirements.
Net Stable Funding and Securitisations (cont.)

- How is Available Stable Funding and Required Stable Funding determined?
- On the ASF side, the principal amount of the funding is multiplied by a factor of between 100% and 0%, depending on the perceived stability of the funding.
- Funding with a maturity of 1 year or more will be assigned a factor of 100%.
- If maturity is less than 1 year, the highest factor that can be obtained for non-deposit funding is 50%.
Net Stable Funding and Securitisations (cont.)

• On the RSF side, the value of the particular asset is multiplied by a factor of between 100% and 0%, depending on the perceived likelihood of being able to realise the value of that asset within a 1 year time frame.

• Assets on the balance sheet that are encumbered for 1 year or more receive a 100% RSF factor.

• Derivative assets are calculated first based on the replacement cost for derivatives contracts (based on market-to-market value) where the contract has a positive value. This will be the net replacement cost where there is in place a bilateral netting contract, meeting certain criteria.
Net Stable Funding and Securitisations (cont.)

- Collateral received in connection with a derivative contract may not off-set the positive replacement amount, except for cash variation margin that is:
  - not segregated;
  - calculated and exchanged on a daily basis, based on mark-to-market valuations;
  - in the same currency as the settlement currency for the derivative contract;
  - in the full amount necessary to fully extinguish the mark-to-market exposure (subject to the threshold and minimum transfer amounts applicable to the counterparty); and
  - covered by a legally enforceable single master netting agreement between the counterparties.

- The liability to repay any remaining variation margin not meeting the above criteria, or any initial margin, shall be assigned a 0% ASF factor.
Net Stable Funding and Securitisations (cont.)

• In terms of RSF factors, these range from a 0% RSF factor for assets such as coins, banknotes and central bank reserves to a 100% RSF factor for:
  ➢ assets that are encumbered for 1 year or more;
  ➢ derivative assets to the extent these exceed derivative liabilities;
  ➢ 20% of derivative liabilities (i.e. negative replacement cost amounts), before deducting posted variation margin; and
  ➢ certain other assets.

• Unencumbered Level 2A assets (for the purpose of the LCR) will receive a 15% RSF factor.

• Unencumbered Level 2B assets will receive a 50% RSF factor. This will include RMBS rated at least AA and any HQLA that are unencumbered or are encumbered for a period of between 6 months and 364 days.

• Unencumbered residential mortgages, and other unencumbered loans to non-financial institutions, with a residual maturity of 1 year or more that would qualify for a 35% or lower risk weight under the Basel II standardised approach for credit risk will receive a 65% RSF factor.
Net Stable Funding and Securitisations (cont.)

- Initial margin posted by the bank for its derivatives liabilities (including under securitisation swaps) and CCP default fund contributions will receive an 85% RSF factor, as will other unencumbered loans not falling within the Basel III 35% risk-weighting category.

- In terms of off-balance sheet contingent obligations provided by banks, a 5% RSF factor is assigned to the currently undrawn portion of irrevocable and conditionally revocable credit and liquidity facilities. For all other contingent funding obligations, national supervisors are given discretion to specify the RSF factors.

- There are some potentially odd results for securitisations from a NSFR viewpoint, including:
  - ABCP with a maturity of 6 months or less has a RSF factor of 50%. Where the ABCP is supported by a credit facility or liquidity facility from a bank, this does not reduce the RSF factor, despite the fact that an unencumbered loan to a bank of less than 6 months would receive a 15% RSF factor (or 10% if collateralised by LCR Level 1 assets that can be freely hypothecated).
Liquidity and Risk Retention

• A bank acting as originator, sponsor or original lender may be compelled to retain a material net economic interest in the securitisation or the underlying assets under risk retention provisions such as Article 405 of CRR.

• Therefore such retained interest will have to be included in the bank’s calculation of its LCR and NSFR.

• However, under the EU’s LCR rules, a securitisation position cannot count as HQLA to the extent that the underlying assets were originated by the bank or any entity closely connected to the bank.

• For the purpose of the NSFR, the retained securitisation bonds or underlying assets will not receive a 50% RSF factor that can be assigned to other LCR Level 2B assets.

• Other than where the underlying assets comprise loans to financial institutions, the best RSF factor that could be obtained would be 65% for unencumbered loans and residential mortgages of 1 year or greater maturity that qualify for a 35% Basel II risk weighting, or otherwise 85% for other unencumbered performing loans or securitisation bonds with a maturity of 1 year or more.
Leverage Ratio

• Basel III, in addition to the existing risk-based capital ratio, introduced a leverage ratio (“LR”), intended to measure the ratio between a bank’s capital, and its non-risk-based assets.
• Following the current period of bank-level reporting to national supervisors of the leverage ratio and its components, the Basel committee intends to complete any final calibrations to its leverage ratio, and any adjustments to the definition, by 2017, with the intention that a minimum leverage ratio requirement will become effective as from 1 January 2018.
• The leverage ratio is defined as being the capital measure, divided by the exposure measure, with a minimum requirement currently being tested of 3% for that leverage ratio.
• The capital measure (numerator) is the bank’s tier 1 capital.
Leverage Ratio – On-Balance Sheet Exposures (cont.)

• The exposure measure is the sum of:
  ➢ on-balance sheet exposures;
  ➢ derivatives exposures;
  ➢ securities financing transaction exposures; and
  ➢ off-balance sheet items.

• In terms of on-balance sheet exposures, banks must include all
  balance sheet assets in the exposure measure, including on-balance
  sheet derivatives collateral and collateral for SFTs, except to the
  extent that these are already covered in the derivatives exposures
  section.

• Liabilities are not to be deducted from the measure of exposure, so
  that gains or losses on fair valued liabilities, or accounting value
  adjustments on derivative liabilities due to changes in the bank’s own
  credit risk, must not be deducted from exposures.
Leverage Ratio – Derivatives Exposures

- Derivatives exposures are calculated at the replacement cost (“RC”) for the current exposure plus an add-on for potential future exposure (“PFE”). However, if the derivative exposure is covered by an eligible bilateral netting contract (see later slide) then an alternative treatment may be applied, by using the net replacement cost of the transaction and with the add-on being calculated on a net basis.
- The applicable PFE add-on is specified in an Annex to final Basel leverage ratio paper, dependent upon the residual maturity of the derivative and the class of asset underlying the derivative.
- Generally, collateral received in connection with derivative contracts may not be netted against the derivative exposures, whether or not netting is permitted under the bank’s accounting or risk-based framework.
- Similarly in respect of collateral provided by a bank, the bank must gross up its exposure measure by the amount of any derivatives collateral provided, where providing that collateral has reduced the value of their balance sheet assets from an accounting point of view.
Leverage Ratio – Derivatives Exposures (cont.)

• The cash portion of variation margin exchanged between counterparties may be viewed as a form of pre-settlement payment, subject to the following conditions:
  ➢ for trades not cleared through a qualifying central counterparty, the cash variation margin is not segregated;
  ➢ variation margin is calculated and exchanged on a daily basis, based on mark-to-market valuation of derivatives positions;
  ➢ the cash variation margin is received in the same currency as the currency of settlement of the derivative contract;
  ➢ variation margin exchanged is the full amount needed to fully extinguish the mark-to-market exposure of the derivative subject to the threshold and minimum transfer amounts applicable to the counterparty; and
  ➢ the derivatives transactions and variation margins are covered by a qualifying single master netting agreement between the two counterparties.
Leverage Ratio – Derivatives Exposures (cont.)

- If the conditions in the previous slide are met, the cash portion of variation margins received by the bank may be used to reduce the replacement cost (but not the add-on portion) of the exposure amount of the derivative asset, so long as the positive mark-to-market value of the derivative has not already been reduced by that margin under the bank’s operative accounting standard.
- If the conditions in the previous slide are met, in respect of cash variation margin provided by the bank to a counterparty, the bank posting the margin may deduct the receivable from its leverage ratio exposure measure if the variation margin has been recognised as an asset under the bank’s accounting framework.
- Cash variation margin may not be used to reduce the potential future exposure add on amount.
- Credit derivatives that are written by the bank (i.e. where the bank is providing credit protection to the counterparty) are to be captured by exposure measure, by including in that measure the effective notional amount referenced by the credit derivative.
Leverage Ratio – Derivatives Exposures (cont.)

• The effective notional amount is obtained by adjusting the notional amount to reflect the true exposure of contracts that are leveraged or otherwise enhanced by the structure of the transaction.

• That effective notional amount can be reduced by any negative change in fair value amount that has been incorporated into the bank’s calculation of tier 1 capital in respect of that derivative.

• The resulting effective notional amount may also be further reduced by the effective notional amount of a credit derivative purchased by the bank on the same reference name, provided that:
  - the purchased credit protection is on a reference obligation which ranks pari passu or junior to the underlying reference obligation of the written credit derivative (in the case of single name credit derivatives); and
  - the remaining maturity of the purchased credit protection is equal to or greater than the remaining maturity of the written credit derivative.

• Since written credit derivatives are included in the exposure measure at their effective notional amount, and are also subject to PFE add-on amounts, this may result in the exposure measure for written credit derivatives being over stated. Therefore banks are allowed to choose to deduct the individual PFE add-on amount for a written credit derivative (so long as this has not been off set according to the measures in the above paragraphs) from their gross add-on amount.
Leverage Ratio - Off-Balance Sheet Items

• These include commitments (including liquidity facilities) that may or may not be unconditionally cancellable, direct credit substitutes, acceptances, standby letters of credit and trade letters of credit.

• For the purpose of determining the exposure amount of OBS items for the leverage ratio, the bank must apply the credit conversion factors specified for that purpose in an Annex to the Basel III leverage ratio framework. This works similarly to the Basel II risk-based framework where OBS items are converted, under the standardised approach, into credit exposure equivalents.

• A 100% credit conversion factor is applied to all off-balance sheet securitisation exposures except for an eligible liquidity facility or an eligible servicer cash advance facility (as set out in paragraph 576 and 578 of the Basel II Framework).

• Eligibility liquidity facilities will receive a CCF of 50%.

• Depending upon national supervisor discretion, undrawn servicer cash advance facilities that are unconditionally cancellable without prior notice, may be eligible for a 10% CCF.
Leverage Ratio - Disclosure

- Banks have been required to publicly disclose their Basel III leverage ratio, on a consolidated basis, since 1 January 2015, including providing:
  - a summary comparison table, comparing the bank’s total accounting assets and leverage ratio exposures;
  - a common disclosure template, providing a break down of the main leverage ratio regulatory elements; and
  - a reconciliation, detailing the sources of material differences between the bank’s total balance sheet assets in its financial statements and on balance sheet exposures in the common disclosure template.
Leverage Ratio - Bilateral Netting

• Subject to the following conditions, banks may apply both payment netting and other forms of nettings, such as close out netting, in determining their exposure amount for the purpose of the leverage ratio.

• The netting contract must create a single legal obligation, covering all included transactions, so that the bank would have an obligation or a right to receive or pay only a single net sum, according to the individual positive and negative mark-to-market values of the individual transactions, if a counterparty fails to perform as a result of its default, bankruptcy, liquidation or similar circumstances.

• The bank must have written and reasoned legal opinions to the effect that in the event of a legal challenge, the relevant courts and authorities would consider the bank’s exposure to be a net amount under:
  ➢ the law of the jurisdiction in which the counterparty is organised and, if its foreign branch is involved, then also under the law of the jurisdiction in which the branch is located;
  ➢ the law that governs the individual transactions; and
  ➢ the law that governs any contract or agreement necessary to effect the netting.
The national supervisor, together with all other relevant supervisors, must be satisfied that the netting is enforceable under the laws of each of the relevant jurisdictions.

The bank must also have procedures in place to ensure that the legal characteristics of its netting arrangements are kept under review, to assess possible changes in relevant law.

Contracts that contain walk-away clauses will not be eligible for netting under the leverage ratio framework.

A walk-away clause is a provision (such as section 1(a)(iii) of the ISDA Master Agreement) that permits a non-defaulting counterparty to make only limited payments, or no payments at all, to the defaulting entity, even if the defaulter is a net creditor.
The Leverage Ratio in Europe

• By 31 December 2016, the European Commission must submit to the European Parliament and the Council a report on the impact and effectiveness of the leverage ratio.

• If the European Commission has concluded that the introduction of a binding leverage ratio is appropriate, the report must be accompanied by a legislative proposal.

• For this purpose, the European Banking Authority is required to report to the European Commission by 31 October 2016 on a large number of issues related to the introduction of the leverage ratio, including whether the leverage ratio framework is the appropriate tool to control the risk of excessive leverage.
The Leverage Ratio in Europe (cont.)

• The report of the EBA must cover at least the period from 1 January 2014 until 30 June 2016 and must take account of issues such as:
  ➢ the impact of introducing the leverage ratio as a binding requirement, on financial markets in general and markets for repos, derivatives and covered bonds in particular and on the robustness of institutions, their risk-taking behaviour and bank lending, particularly to SMEs, local authorities, regional governments and public sector entities;
  ➢ the interaction of the leverage ratio with the risk-based capital requirements and the liquidity requirements; and
  ➢ the impact of accounting differences, between different applicable accounting standards, on the comparability of the leverage ratio.
Other Rules Impacting Securitisations – U.S.

• Swaps in securitisations:
  ➢ clearing and margin rules for swaps are established by the Commodity Futures Trading Commission (CFTC);
  ➢ CFTC and other regulators were not amenable to treating securitisations as end users not subject to the margin rules;
  ➢ however, securitisation swaps are generally uncleared; idiosyncratic swaps – what are they?;
  ➢ nevertheless, margin rules also apply to uncleared swaps:
    ▪ initial margin – not required unless the SPE has ‘material swaps exposure”, i.e., $8 billion; and
    ▪ variation margin – is required.
  ➢ the industry clings to the hope that the CFTC may yet provide no-action relief to the requirement for variation margin for securitisations.

• LCR HQLA charge – see discussion above.
Other Rules Impacting Securitisations – U.S. (cont.)

• Regulation AB – applies to registered ABS:
  
  ➢ CEO certifications;
  ➢ due diligence reports; and
  ➢ loan-level disclosure.

• Risk Retention – applies to all ABS
  
  ➢ 5% risk retention:
    ▪ horizontal – must be 5% of *fair* value
      o disclose methodology
    ▪ vertical – 5% of face amount of each class
  
  ➢ For certain qualifying assets, the risk retention amount is reduced

• Money market fund reform – reduced purchase of ABCP.
• Conflicts of interest – yet to come.
• GSE Reform – yet to come.
• Volcker Rule – “covered funds”:
  ➢ all securitisations rely on an exemption from the requirement to register as an investment company under the Investment Company Act of 1940;
  ➢ the Volcker Rule sharply limits the ability of banks to hold “ownership interests” in hedge funds and private equity funds (“covered funds”);
  ➢ the rule defined hedge funds and private equity funds as entities that rely on Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act for an exemption from the requirement to register;
  ➢ but many securitisations also rely on those same sections for their exemption from the requirement to register and therefore are covered funds;
  ➢ there are also limitations on transactions that a bank may enter into with a covered fund if the bank acts as an investment advisor or sponsor of the fund or holds an ownership interest in the covered fund; and
  ➢ this limits loans to the covered fund, purchase of its securities or assets, taking its securities as collateral, a guarantee of the fund, any securities borrowing or lending or derivative transaction that creates a credit exposure to the fund.
• Volcker Rule – proprietary trading:
  ➢ the rule also prohibits banks from “proprietary trading” in financial instruments, with certain limited exceptions, e.g., certain underwriting, marketmaking and hedging activities; and
  ➢ there is a rebuttable presumption of proprietary trading if a security is held for less than 60 days.
EMIR and Securitisation Swaps

- Compulsory central clearing of derivatives, this will only apply to entities that are financial counterparties, or non-financial counterparties with outstanding derivatives above a certain threshold, or to non-EU counterparties who are equivalent to the above.

- An SPV would not qualify as a financial counterparty, because it does not carry out activities requiring regulation under the regulations specified under EMIR. However, in the case of an on-balance sheet securitisation, a bank would count as a financial counterparty (or equivalent to one, if not organised in the EU).

- An SPV is unlikely to constitute an above-threshold non-financial counterparty, unless it carried out multiple securitisations. This is because the threshold for interest rate swaps and FX derivatives is EUR3 billion, and the threshold for credit derivatives, in the case of a synthetic securitisation, is EUR1 billion.

- Therefore an SPV is unlikely to be required to clear its swaps centrally.

- Compulsory reporting of trade details to trade repositories will apply to the securitiser if it is EU-incorporated, or otherwise to any EU-incorporated counterparty that it faces.
EMIR and Securitisation Swaps (cont.)

- Compulsory margin requirements for uncleared swaps have yet to become effective, but when they do, they will be directly binding only on EU financial counterparties and above-threshold non-financial counterparties.
- Therefore they will affect EU banks for on-balance sheet securitisations, though probably not SPVs.
- Subject to a number of specific conditions, covered bond swaps are expressly exempted from the margin requirements, though securitisation swaps are not.
- EU financial counterparties and above-threshold non-financial counterparties will be required (with certain exceptions) to collect initial and variation margin from their counterparties, meaning a securitiser could potentially be required to provide margin if it is facing an EU counterparty.
- Collecting initial margin is not compulsory in the case of FX forwards, FX swaps and currency swaps.
- It is also not compulsory where the total amount of initial margin that would otherwise be required to be collected is no greater than EUR50 million, nor where either of the swap counterparties belongs to a group which has an aggregate average notional amount of non-cleared derivatives below EUR8 billion.
EMIR and Securitisation Swaps (cont.)

• In addition, parties subject to these provisions of EMIR are not required to collect initial or variation margin from sub-threshold EU non-financial counterparties, nor from third country entities that are equivalent to sub-threshold EU non-financial counterparties.

• Therefore, an SPV is unlikely to be required to provide initial or variation margin. However, a bank securitiser, facing an EU financial counterparty or an above-threshold EU non-financial counterparty, would be required to post variation margin, and initial margin (assuming it does not fall within any of the available exemptions).
Contact Details

Peter Green
Tel: +44 20 7920 4013
Email: pgreen@mofo.com

Jeremy Jennings-Mares
Tel: +44 20 7920 4072
Email: jjenningsmares@mofo.com

Jerry Marlatt
Tel: +1 (212) 468-8024
Email: jmarlatt@mofo.com
LCR – The Fed Takes Tentative Step to Expand HQLAs

When 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”) finalized the Liquidity Coverage Ratio (the “LCR”) in September 2014, they excluded municipal securities from qualifying as high-quality liquid assets (“HQLAs”) under the rule. However, the Board stated that it would continue to examine whether at least some U.S. municipal securities could be included as eligible HQLAs. On May 21, 2015, the Board invited public comment on a proposed rule that allows Board-supervised institutions that are subject to the LCR to count certain U.S. municipal securities as HQLAs, subject to limitations related to the amount outstanding of a particular issuance, the average daily trading volume of an issuer’s municipal securities and a cap on the amount of municipal securities that can count as HQLAs.

Application

The proposed rule only applies to bank holding companies, certain savings and loan holding companies, state member banks and nonbank financial companies designated by the Financial Stability Oversight Council for Board supervision to which the Board has applied the LCR by rule or order. The proposed rule does not apply to OCC or FDIC regulated institutions, but as a practical matter, these institutions would benefit from the application of the proposed rule to their holding companies.

Inclusion of U.S. Municipal Securities as Eligible HQLAs

Criteria

The proposed rule allows certain U.S. general obligation municipal securities to count as level 2B HQLAs. The municipal securities must satisfy requirements similar to those that level 2B corporate debt securities must satisfy. They must be liquid and readily marketable, investment grade under 12 CFR part 1, issued by a public sector entity whose securities have a demonstrated record as a reliable source of liquidity in repurchase or sales markets during stressed market conditions, and they cannot be an obligation of a financial sector entity or its consolidated subsidiaries. Under the proposed rule, a security that is issued or guaranteed by a financial sector entity is considered to be an obligation of that entity. Therefore, if a general obligation municipal security is insured by a bond insurer, such a security cannot be included as an eligible HQLA. The liquidity of the securities must be demonstrated by a record of market prices declining and collateral haircuts increasing by no more than 20% during a 30-calendar-day period of significant stress.
**Limitations**

The proposed rule limits the amount of general obligation municipal securities that a covered institution can consider HQLAs in three ways. First, a covered institution can only count a particular municipal security holding as an eligible HQLA if it does not exceed, on a fair value basis, 25% of the total amount of outstanding securities with the same CUSIP number. This calculation should be made before the 50% haircut that is applicable to level 2B liquid assets. Second, the aggregate fair value of the municipal securities included as eligible HQLAs cannot exceed two times the average daily trading volume of all general obligation municipal securities issued by that issuer. Lastly, municipal securities cannot exceed 5% of an institution’s total HQLAs. The 5% limit applies both on an unadjusted basis and after taking account of the unwind applicable to certain secured funding transactions, secured lending transactions, asset exchanges and collateralized derivatives transactions.

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**Author**

Oliver Ireland  
Washington, D.C.  
+1 (202) 778-1614  
oireland@mofo.com

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*Because of the generality of this update, the information provided herein may not be applicable in all situations and should not be acted upon without specific legal advice based on particular situations.*
The Liquidity Coverage Ratio (the “LCR” or the “rule”) adopted by 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”) (collectively, the “agencies”) requires covered institutions to maintain a stock of high-quality liquid assets (“HQLAs”) sufficient to satisfy their projected net cash outflows over a 30-day period as computed under the rule.

Over time, covered institutions will find that modifications to the structure and terms of their assets and liabilities, coupled with educated choices about which HQLAs they hold to cover the gap between calculated outflows and inflows, can both improve their ability to withstand liquidity pressures and minimize any adverse effects on revenues that may result from holding the necessary level of HQLAs. The following analysis of the LCR is designed to help covered institutions achieve compliance with the rules and to help them start the process of making that compliance more efficient.

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I. LCR COVERAGE AND TIMING

There are two forms of the LCR. There is a version for large, internationally active banking organizations with $250 billion or more in total consolidated assets or $10 billion or more in on-balance sheet foreign exposure, and for consolidated depository institution subsidiaries of these companies with $10 billion or more in total consolidated assets. There is also a modified LCR (the “Modified LCR”) that is somewhat less stringent. The Modified LCR applies to bank holding companies and savings and loan holding companies without significant insurance or commercial operations that have $50 billion or more in total consolidated assets.

The effective dates and calculation requirements for covered companies differ based on the size of the institution. The following tables lay out the relevant requirements:

**Transition Period for the Liquidity Coverage Ratio**

<table>
<thead>
<tr>
<th>Time Period</th>
<th>Liquidity Coverage Ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td>Calendar year 2015</td>
<td></td>
</tr>
<tr>
<td>Calendar year 2016</td>
<td></td>
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<tr>
<td>Calendar year 2017 and thereafter</td>
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</tr>
</tbody>
</table>

**Calculation Frequency**

For covered 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 total consolidated assets equal to $10 billion or more:

- Last business day of the calendar month: Beginning January 1, 2015
- Each business day: Beginning July 1, 2015

All other covered companies:

- Last business day of the calendar month: Beginning January 1, 2015
- Each business day: Beginning July 1, 2016

**Transition Period for the Modified Liquidity Coverage Ratio**

<table>
<thead>
<tr>
<th>Time Period</th>
<th>Liquidity Coverage Ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td>Calendar year 2016</td>
<td></td>
</tr>
<tr>
<td>Calendar year 2017 and thereafter</td>
<td></td>
</tr>
</tbody>
</table>

**Calculation Frequency**

Last business day of the calendar month beginning January 1, 2016.
II. THE LIQUIDITY COVERAGE RATIO

Conceptually, the LCR is relatively simple and can be expressed by the following formula: \( \frac{HQLAs}{Total\ Net\ Cash\ Outflow\ Amount} \geq 1 \). In other words, an institution must calculate its total net cash outflows over a 30-day measurement period, and if the result of that calculation is a number greater than zero, the institution must hold a commensurate amount of HQLAs that can be liquidated to meet the assumed outflows. The equation requires unpacking to fully appreciate the complexity involved in its calculation.

First, the LCR must be calculated and maintained on a daily basis, except for those institutions subject to the Modified LCR, which need only calculate the LCR on the last day of each calendar month.

Under the rule, HQLAs are subdivided into three classes: Level 1, Level 2A and Level 2B assets. Level 1 assets receive 100% credit. Level 2A assets receive 85% credit and Level 2B assets receive 50% credit. Level 2 assets are capped at 40% of total HQLAs and Level 2B assets are capped at 15% of total HQLAs. The LCR also requires that HQLAs be “eligible,” such that they can be easily liquidated, from an operational standpoint, within the 30-day measurement period. In addition, HQLAs are subject to an adjustment that “unwinds” specific types of secured transactions that mature within 30 days of the calculation date.

A covered company’s total net cash outflow amount is derived by adding up total cash outflows over a 30-day period, subtracting total cash inflows over the same period and then applying a maturity mismatch add-on. Total cash inflows under the rule are subject to a 25% haircut, so that even if a covered company’s total cash inflows matched its total cash outflows, it would still need to maintain a cushion of HQLAs. In order to calculate the amount of its cash inflows and outflows, a covered institution must determine the maturity and type of each of its transactions. The rule provides a prescribed set of maturity assumptions. Outflow and inflow rates can be assigned once the maturity and the type of each transaction are determined under the rule. The maturity assumptions generally presume that all contingencies, such as the exercise of a put or call option, are realized to the disadvantage of covered institutions (i.e., maturities for outflows will be shortened and maturities for inflows will be extended). The result of these various maturity assumptions, transaction classifications and corresponding outflow and inflow rates is a complex matrix of fund flows that will ultimately shape institutions’ preferences for certain types of transactions based on the effect of those transactions on the LCR calculation.

III. HIGH-QUALITY LIQUID ASSETS

HQLAs are divided into three tiers based on the agencies’ perception of the ease with which various assets can be sold, while maintaining a minimum level of price integrity, during a time of market stress. The agencies also endeavor to ensure that covered institutions have the practical and operational ability to convert their HQLAs into cash in time to meet projected liquidity demands.

Level 1

Level 1 assets are those assets in which the agencies have the highest confidence. They are the only HQLAs that can be counted at their undiscounted fair value, although they are subject to a deduction for any applicable reserve requirement. Level 1 assets consist of:

1. Reserve balances, both domestic and foreign, that are withdrawable without restriction;\(^1\)

2. Securities issued or guaranteed by the U.S. Treasury;

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\(^1\) Domestic reserve requirements are deducted from Level 1 assets in calculating the HQLA amount. This deduction is based on balances maintained at Federal Reserve Banks and excludes reserve requirements to the extent that they are met with vault cash.
3. Securities issued or guaranteed by other U.S. government agencies that are backed by the full faith and credit of the U.S. government and that are liquid and readily-marketable;

4. Securities, issued or guaranteed by a foreign government, central bank, the Bank for International Settlements, the International Monetary Fund, the European Central Bank, the European Community or a multilateral development bank, that have a zero percent risk weight under the agencies’ risk-based capital rules, are liquid and readily-marketable, and are issued by an entity outside of the financial sector whose securities have a demonstrated record as a reliable source of liquidity in repurchase or sales markets during stressed market conditions; and

5. Securities issued by a sovereign entity (i.e., a foreign central government or central bank) that do not have a zero percent risk weight under the agencies’ risk-based capital rules, but that are liquid and readily-marketable, issued in the currency of the sovereign and held to meet net cash outflows in the jurisdiction of the sovereign.

Level 2A

Level 2A assets are discounted to 85% of fair value. Level 2A assets must be liquid and readily-marketable and consist of:

1. U.S. government-sponsored enterprise (“GSE”) securities that are investment grade under 12 CFR part 1 and are senior to preferred stock; and

2. Securities issued by a sovereign entity or a multilateral development bank that are not Level 1 assets, but that have no higher than a 20% risk weight under the agencies’ risk-based capital rules, and are issued by an entity outside of the financial sector whose securities have a demonstrated record as a reliable source of liquidity in repurchase or sales markets during stressed market conditions. The liquidity of these securities must be demonstrated by a record of market prices declining and collateral haircuts increasing by no more than 10% during a 30-calendar day period of significant stress.

Level 2B

Level 2B assets are discounted to 50% of fair value. Level 2B assets must be liquid and readily-marketable and consist of:

1. Corporate debt that is investment grade under 12 CFR part 1, and that is issued by an entity outside of the financial sector whose securities have a demonstrated record as a reliable source of liquidity in repurchase or sales markets during stressed market conditions. The liquidity of these securities must be demonstrated by a record of market prices declining and collateral haircuts increasing by no more than 20% during a 30-calendar day period of significant stress; and

2. Publicly traded common equity securities that are:
   a. included in the Russell 1000 Index or an index recognized, for the purposes of the LCR rules, by a foreign regulator for securities held in that foreign jurisdiction;
   b. issued in U.S. dollars or in the currency where the security is held to cover net outflows in that jurisdiction;

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2 A security is liquid and readily-marketable if it is traded in an active secondary market with more than two committed market makers, a large number of other participants on both the buy- and sell-side of the market, timely and observable market prices and a high trading volume.
c. issued by an entity outside of the financial sector whose securities have a demonstrated record as a reliable source of liquidity in repurchase or sales markets during stressed market conditions. The liquidity of these securities must be demonstrated by a record of market prices declining and collateral haircuts increasing by no more than 40% during a 30-calendar day period of significant stress;

d. not acquired by a depository institution due to debt previously contracted; and

e. held by a consolidated subsidiary of a depository institution, but only if they are used to cover net outflows by that subsidiary.

Amount and Eligibility

In calculating its HQLAs under the rule, a covered company must account for the haircuts on Level 2A and Level 2B assets, the cap on the total amount of Level 2 assets of 40% of total HQLAs and the cap on Level 2B assets of 15% of total HQLAs. The caps are calculated both before and after a simulated unwind of the following transactions that involve the exchange of HQLAs between the covered company and its counterparty and mature within 30 days of the calculation date: 1) secured funding transactions other than collateralized deposits, 2) secured lending transactions, 3) asset exchanges, and 4) collateralized derivative transactions. The calculation that results in the smaller value for the capped assets is used to calculate the total amount of HQLAs.

HQLAs must also be available for use by a covered institution to meet liquidity requirements, or “eligible,” to be included in the amount of HQLAs.

To be eligible, assets:

1. Must be unencumbered;

2. Must not be client pool securities from a separate account;

3. If held by a consolidated subsidiary, must be used to cover outflows at the consolidated subsidiary and then be available for transfer to the parent in times of market stress without statutory, contractual, regulatory or supervisory restrictions;

4. Cannot be subject to withdrawal by a counterparty or beneficial owner during the 30-day period; and

5. Cannot be designated to cover operational costs.

To be eligible, assets must also meet certain operational requirements:

1. The covered company must demonstrate that it can monetize the asset by implementing appropriate procedures and systems and periodically monetizing a sample of assets;

2. The assets must be demonstrably under the control of the liquidity risk management function at the covered institution;

3. The value of the assets must be reduced by the costs of terminating related hedging transactions; and

4. The covered institution must have policies and procedures to consistently identify eligible HQLAs and to appropriately diversify its HQLAs.
IV. NET OUTFLOWS

Measurement

A covered company’s total net cash outflows is equal to 1) the sum of the outflow amounts calculated under the rule, 2) minus the lesser of (a) the sum of the inflow amounts, and (b) 75% of the cumulative outflow amount, 3) plus a maturity mismatch add-on that accounts for the possibility that outflows may occur prior to inflows during the 30-day period. The add-on is equal to the difference between the net cumulative outflow amount at the end of the 30-day period and the peak net cumulative outflow amount during the 30-day period.

Because both cash and HQLAs go into the calculation of the LCR, outflows of both cash and HQLAs are considered in arriving at the final ratio.

Maturity

For the purpose of calculating outflows, covered institutions must assume the earliest possible maturity date for their obligations. Except for two special cases, covered institutions must assume that all options to shorten maturities are exercised regardless of whether the option is a put to the institution or a call by the institution. Notice periods for options are disregarded for the purpose of measuring maturity. The exceptions to the rule of thumb for outflow-related maturity assumptions are 1) obligations with an original maturity of greater than one year where the institution has a call option that does not go into effect for 180 days following the issuance of the obligation and 2) where the counterparty is a sovereign entity, a GSE or a public sector entity.

For purposes of calculating inflows, covered institutions must assume the latest possible maturity date and that options will always be exercised to extend, rather than shorten, the maturity date. The institution must also assume that any notice period will be enforced by a counterparty.

Notwithstanding these general rules, in an exercise of judgment, the agencies have tailored certain rules for specific types of transactions. For secured lending transactions and asset exchange transactions that are secured by collateral that is then pledged in a secured funding transaction or another asset exchange transaction, the maturity date is the later of the maturity dates of the linked transactions. For the following transactions that have no maturity date and are not operational deposits, the maturity date under the rule is the day after the calculation date: 1) on the outflow side, (a) secured funding transactions, (b) asset exchanges, (c) foreign central bank borrowing, and (d) specified unsecured wholesale funding transactions; and 2) on the inflow side, (a) unsecured wholesale funding, (b) secured lending transactions and (c) asset exchange transactions. Any other outflow with no maturity date is considered to mature within 30 days of the calculation date. Other inflows with no maturity date are not counted as inflows for the purpose of the net cash outflow calculation. Finally, for broker-dealer segregated account inflows, the maturity date is the date of the next calculation of the amount required for the protection of customer assets.

V. OUTFLOWS BY TRANSACTION TYPE

The rule identifies classes of outflows and specific outflow rates for numerous sub-classifications of transactions within these classes. While there is some consistency in the judgments underlying these individual outflow rates, the rates do not lend themselves to simple rules of thumb. The following table identifies the LCR outflow rates by class and subclass. Unless otherwise specified, transactions mature within 30 days of the calculation date. Outflows exclude transactions with and between consolidated subsidiaries of the covered institution.
## Outflows

<table>
<thead>
<tr>
<th>TRANSACTIONS</th>
<th>OUTFLOW RATES</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Retail Funding</strong></td>
<td></td>
</tr>
<tr>
<td>Stable retail deposits</td>
<td>3%</td>
</tr>
<tr>
<td>Other retail deposits</td>
<td>10%</td>
</tr>
<tr>
<td>Fully insured non-brokered third-party deposits</td>
<td>20%</td>
</tr>
<tr>
<td>Non-brokered third-party deposits that are not fully insured</td>
<td>40%</td>
</tr>
<tr>
<td>Other retail funding that is not a retail deposit, brokered deposit or debt instrument</td>
<td>40%</td>
</tr>
<tr>
<td><strong>Structured Transactions</strong></td>
<td></td>
</tr>
<tr>
<td>Non-consolidated issuer and sponsored by the covered institution</td>
<td>The greater of a) 100% of the obligations that mature within 30 days and b) the maximum funding obligation of the covered institution to the issuer over the next 30 days</td>
</tr>
<tr>
<td><strong>Derivatives-Net</strong></td>
<td></td>
</tr>
<tr>
<td>Net payments under master netting agreements</td>
<td>100%</td>
</tr>
<tr>
<td>Net payments in principal exchanges in FX transactions</td>
<td>100%</td>
</tr>
<tr>
<td><strong>Mortgage Commitments</strong></td>
<td></td>
</tr>
<tr>
<td>Retail mortgage commitments that can be drawn within 30 days</td>
<td>10%</td>
</tr>
<tr>
<td><strong>Other Commitments</strong></td>
<td></td>
</tr>
<tr>
<td>Credit and liquidity facilities for an affiliated depository institution subject to the rule</td>
<td>0%</td>
</tr>
<tr>
<td>Credit and liquidity facilities for retail customers</td>
<td>5%</td>
</tr>
<tr>
<td>Credit facilities for wholesale customers that are not in the financial sector</td>
<td>10%</td>
</tr>
<tr>
<td>Liquidity facilities for wholesale customers that are not in the financial sector</td>
<td>30%</td>
</tr>
<tr>
<td>Credit and liquidity facilities for depository institutions, depository</td>
<td>50%</td>
</tr>
<tr>
<td>Institution Holding Companies and Foreign Banks</td>
<td>40%</td>
</tr>
<tr>
<td>Credit Facilities for Financial Sector Entities</td>
<td>40%</td>
</tr>
<tr>
<td>Liquidity Facilities for Financial Sector Entities</td>
<td>100%</td>
</tr>
<tr>
<td>Credit and Liquidity Facilities for Special Purpose Entities that are Used to Finance Purchases or Operations</td>
<td>100%</td>
</tr>
<tr>
<td>Other Credit or Liquidity Facilities</td>
<td>100%</td>
</tr>
<tr>
<td><strong>Collateral</strong></td>
<td></td>
</tr>
<tr>
<td>Additional Amounts the Institution Could Be Required to Pledge Due to Changes in Its Financial Condition</td>
<td>100%</td>
</tr>
<tr>
<td>Fair Value of Collateral That is Not a Level 1 Asset and That is Pledged to Secure Derivative Transactions</td>
<td>20%</td>
</tr>
<tr>
<td>Absolute Value of the Largest 30-Day Mark-to-Market Collateral Inflow or Outflow for a Derivative Transaction in the Last 24 Months</td>
<td>100%</td>
</tr>
<tr>
<td>Excess Collateral Due to a Counterparty</td>
<td>100%</td>
</tr>
<tr>
<td>Not Yet Pledged Collateral Due to a Counterparty</td>
<td>100%</td>
</tr>
<tr>
<td>Level 1 Assets Pledged to the Institution Where Other Level 1 Assets Can Be Substituted</td>
<td>0%</td>
</tr>
<tr>
<td>Level 1 Assets Pledged to the Institution Where Level 2A Assets Can Be Substituted</td>
<td>15%</td>
</tr>
<tr>
<td>Level 1 Assets Pledged to the Institution Where Level 2B Assets Can Be Substituted</td>
<td>50%</td>
</tr>
<tr>
<td>Level 1 Assets Pledged to the Institution Where Non-HQLAs Can Be Substituted</td>
<td>100%</td>
</tr>
<tr>
<td>Level 2A Assets Pledged to the Institution Where Level 1 or Level 2A Assets Can Be Substituted</td>
<td>0%</td>
</tr>
<tr>
<td>Level 2A Assets Pledged to the Institution Where Level 2B Assets Can Be Substituted</td>
<td>35%</td>
</tr>
<tr>
<td>Level 2A Assets Pledged to the Institution Where Non-HQLAs Can Be Substituted</td>
<td>85%</td>
</tr>
<tr>
<td>Level 2B Assets Pledged to the Institution Where Other HQLAs Can Be Substituted</td>
<td>0%</td>
</tr>
<tr>
<td>Level 2B Assets Pledged to the Institution Where Non-HQLAs Can Be Substituted</td>
<td>50%</td>
</tr>
<tr>
<td><strong>Brokered Deposits-Retail</strong></td>
<td></td>
</tr>
<tr>
<td>General Retail Brokered Deposits that Maturing within 30 Days</td>
<td>100%</td>
</tr>
<tr>
<td>Description</td>
<td>Percentage</td>
</tr>
<tr>
<td>----------------------------------------------------------------------------</td>
<td>------------</td>
</tr>
<tr>
<td>General retail brokered deposits with a maturity of more than 30 days</td>
<td>10%</td>
</tr>
<tr>
<td>General retail brokered deposits fully covered by deposit insurance with no maturity date</td>
<td>20%</td>
</tr>
<tr>
<td>General retail brokered deposits that are not fully insured with no maturity date</td>
<td>40%</td>
</tr>
<tr>
<td>Reciprocal brokered deposits that are fully insured</td>
<td>10%</td>
</tr>
<tr>
<td>Reciprocal brokered deposits that are not fully insured</td>
<td>25%</td>
</tr>
<tr>
<td>Broktered sweep deposits received from an affiliate that are fully insured</td>
<td>10%</td>
</tr>
<tr>
<td>Broktered sweep deposits that are not received from an affiliate that are fully insured</td>
<td>25%</td>
</tr>
<tr>
<td>Broktered sweep deposits that are not received from an affiliate and are not fully insured</td>
<td>40%</td>
</tr>
<tr>
<td><strong>Unsecured Wholesale Funding</strong></td>
<td></td>
</tr>
<tr>
<td>General unsecured wholesale funding that is fully insured</td>
<td>20%</td>
</tr>
<tr>
<td>General wholesale funding that is not fully insured or is a brokered deposit</td>
<td>40%</td>
</tr>
<tr>
<td>General wholesale funding that is brokered</td>
<td>40%</td>
</tr>
<tr>
<td>Other general wholesale funding, including funding from affiliates and retail debt instruments</td>
<td>100%</td>
</tr>
<tr>
<td>Operational deposits, other than escrow accounts, that are fully insured</td>
<td>5%</td>
</tr>
<tr>
<td>Other operational deposits</td>
<td>25%</td>
</tr>
<tr>
<td>Other wholesale funding</td>
<td>100%</td>
</tr>
<tr>
<td><strong>Debt Security Buybacks</strong></td>
<td></td>
</tr>
<tr>
<td>Non-structured debt securities with a maturity of more than 30 days for which the covered institution or a consolidated subsidiary is the primary market maker</td>
<td>3%</td>
</tr>
<tr>
<td>Structured debt securities with a maturity of more than 30 days for which the covered institution or a consolidated subsidiary is the primary market maker</td>
<td>5%</td>
</tr>
<tr>
<td><strong>Secured Funding</strong></td>
<td></td>
</tr>
<tr>
<td>In some cases, unsecured funding outflow rate may be used</td>
<td></td>
</tr>
<tr>
<td>Secured by Level 1 assets</td>
<td>0%</td>
</tr>
<tr>
<td>Secured by Level 2A assets</td>
<td>15%</td>
</tr>
<tr>
<td>---------------------------</td>
<td>-----</td>
</tr>
<tr>
<td>Funds received from sovereign entities, multilateral development banks and GSEs with a 20% risk weight under the agencies' capital rules that are not secured by Level 1 or Level 2A assets</td>
<td>25%</td>
</tr>
<tr>
<td>Secured by Level 2B assets</td>
<td>50%</td>
</tr>
<tr>
<td>Funds received to secure customer short positions that are covered by other customers' non-HQLA collateral</td>
<td>50%</td>
</tr>
<tr>
<td>Other secured funding transactions that are not secured by HQLAs</td>
<td>100%</td>
</tr>
</tbody>
</table>

### Asset Exchanges

<table>
<thead>
<tr>
<th>Give Level 1 assets get Level 1 assets</th>
<th>0%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Give Level 1 assets get Level 2A assets</td>
<td>15%</td>
</tr>
<tr>
<td>Give Level 1 assets get Level 2B assets</td>
<td>50%</td>
</tr>
<tr>
<td>Give Level 1 assets get non-HQLAs</td>
<td>100%</td>
</tr>
<tr>
<td>Give Level 2A assets get Level 1 or Level 2A assets</td>
<td>0%</td>
</tr>
<tr>
<td>Give Level 2A assets get Level 2B assets</td>
<td>35%</td>
</tr>
<tr>
<td>Give Level 2A assets get non-HQLAs</td>
<td>85%</td>
</tr>
<tr>
<td>Give Level 2B assets get HQLAs</td>
<td>0%</td>
</tr>
<tr>
<td>Give Level 2B assets get non-HQLAs</td>
<td>50%</td>
</tr>
<tr>
<td>Covered institution will receive Level 1 assets but has rehypothecated the counterparty’s collateral and the collateral will not be returned within 30 days</td>
<td>0%</td>
</tr>
<tr>
<td>Covered institution will receive Level 2A assets but has rehypothecated the counterparty’s collateral and the collateral will not be returned within 30 days</td>
<td>15%</td>
</tr>
<tr>
<td>Covered institution will receive Level 2B assets but has rehypothecated the counterparty’s collateral and the collateral will not be returned within 30 days</td>
<td>50%</td>
</tr>
<tr>
<td>Covered institution will receive non-HQLAs but has rehypothecated the counterparty’s collateral and the collateral will not be returned within 30 days</td>
<td>100%</td>
</tr>
</tbody>
</table>

### Foreign Central Bank Borrowings

As specified in the liquidity standards of the foreign jurisdiction. If there are none, then it is treated as a secured funding transaction.
VI. INFLOWS BY TRANSACTION TYPE

The rule identifies classes of inflows and specific inflow rates for numerous sub-classifications of transactions within these classes. While there is some consistency in the judgments underlying these individual inflow rates, the rates do not lend themselves to simple rules of thumb. The following table identifies the LCR inflow rates by class and subclass. Unless otherwise specified, transactions mature within 30 days of the calculation date.

Inflows exclude:

1. Transactions with consolidated subsidiaries of the institution and between consolidated subsidiaries of the institution;
2. Amounts held in operational deposits at other regulated financial institutions;
3. Amounts due on forward sales of mortgage loans and derivatives that are mortgage commitments;
4. Amounts available from credit or liquidity facilities;
5. The amount of any eligible HQLA and any amount payable to the institution with respect to that HQLA;
6. Amounts payable on nonperforming assets and assets that the institution has reason to believe will become nonperforming within 30 days; and
7. Amounts with no maturity date or that mature more than 30 days after the calculation date.

<table>
<thead>
<tr>
<th>TRANSACTIONS</th>
<th>INFLOW RATES</th>
</tr>
</thead>
<tbody>
<tr>
<td>Derivatives-Net</td>
<td></td>
</tr>
<tr>
<td>Net receipts under master netting agreement</td>
<td>100%</td>
</tr>
<tr>
<td>Net receipts in principal exchanges in FX transactions</td>
<td>100%</td>
</tr>
<tr>
<td>Retail</td>
<td></td>
</tr>
<tr>
<td>Payments due from retail customers</td>
<td>50%</td>
</tr>
<tr>
<td>Unsecured Wholesale Funding</td>
<td></td>
</tr>
<tr>
<td>Payments due from financial sector entities</td>
<td>100%</td>
</tr>
<tr>
<td>Payments due from non-financial sector entities (excludes payments on revolving credit facilities)</td>
<td>50%</td>
</tr>
<tr>
<td>Securities</td>
<td></td>
</tr>
<tr>
<td>---------------------------------------------------------------------------</td>
<td>---</td>
</tr>
<tr>
<td>Payments due on securities owned that are not eligible HQLAs</td>
<td>100%</td>
</tr>
<tr>
<td>Secured Lending</td>
<td></td>
</tr>
<tr>
<td>Payments due where the collateral has been rehypothecated and will not be returned within 30 days</td>
<td>0%</td>
</tr>
<tr>
<td>Payments due where collateral is not HQLAs and it is still held by the covered institution</td>
<td>100%</td>
</tr>
<tr>
<td>Other secured lending transactions secured by Level 1 assets</td>
<td>0%</td>
</tr>
<tr>
<td>Other secured lending transactions secured by Level 2A assets</td>
<td>15%</td>
</tr>
<tr>
<td>Other secured lending transactions secured by Level 2B assets</td>
<td>50%</td>
</tr>
<tr>
<td>Other secured lending transactions secured by non-HQLAs</td>
<td>100%</td>
</tr>
<tr>
<td>Asset Exchanges</td>
<td></td>
</tr>
<tr>
<td>Covered institution will receive assets but has rehypothecated the counterparty’s collateral and the collateral will not be returned within 30 days</td>
<td>0%</td>
</tr>
<tr>
<td>Give Level 1 assets get Level 1 assets</td>
<td>0%</td>
</tr>
<tr>
<td>Give Level 1 assets get Level 2A assets</td>
<td>15%</td>
</tr>
<tr>
<td>Give Level 1 assets get Level 2B assets</td>
<td>50%</td>
</tr>
<tr>
<td>Give Level 1 assets get non-HQLAs</td>
<td>100%</td>
</tr>
<tr>
<td>Give Level 2A assets get Level 1 or Level 2A assets</td>
<td>0%</td>
</tr>
<tr>
<td>Give Level 2A assets get Level 2B assets</td>
<td>35%</td>
</tr>
<tr>
<td>Give Level 2A assets get non-HQLAs</td>
<td>85%</td>
</tr>
<tr>
<td>Give Level 2B assets get HQLAs</td>
<td>0%</td>
</tr>
<tr>
<td>Give Level 2B assets get non-HQLAs</td>
<td>50%</td>
</tr>
<tr>
<td>Broker-Dealer Segregated Accounts</td>
<td></td>
</tr>
<tr>
<td>Projected amount to be released based on assuming inflows and outflows under the rule</td>
<td>100%</td>
</tr>
<tr>
<td>Other Inflows</td>
<td></td>
</tr>
<tr>
<td>Other inflows not specified above</td>
<td>0%</td>
</tr>
</tbody>
</table>
VII. MODIFIED LIQUIDITY COVERAGE RATIO

Depository institution holding companies that are not covered by the standard LCR but that have total consolidated assets of $50 billion or more must calculate the LCR on the last day of each calendar month, rather than on a daily basis. In addition, for these holding companies, the applicable total net cash outflow amount is only 70% of its otherwise calculated net cash outflow amount.

VIII. SHORTFALLS

Covered institutions must report shortfalls in their LCR to their regulators. For monthly calculators, each shortfall must be reported and the institution must consult with the regulator to determine whether a plan for achieving compliance will be required. For daily calculators, a compliance plan is required if the shortfall continues for three consecutive days.

AUTHOR

Oliver I. Ireland
Washington, D.C.
(202) 778-1614
OlIreland@mofo.com

RESOURCES

Access our free tools and resources to keep abreast of regulatory changes:

Regulatory Reform Glossary

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Because of the generality of this update, the information provided herein may not be applicable in all situations and should not be acted upon without specific legal advice based on particular situations.
FROM
EMIR TO
ETERNITY?

The EU Financial Regulatory Agenda Into
2015 and Beyond
2014 was a very active year for financial regulation in the European Union (EU). There was a push to finalise much of the outstanding primary legislation on the regulatory reform agenda in advance of the European Parliamentary elections in May 2014. This resulted in the adoption of many EU Regulations and Directives in the first half of the year. However, much still remains in the in-box of EU legislators and regulators. Most of the legislation that has been adopted envisages a significant amount of further legislation and rulemaking regulation in the form of delegated regulations to be adopted by the EU Commission, much of it to comprise regulatory technical standards (RTS) and implementing technical standards (ITS) to be drafted by the European Supervisory Authorities (the ESAs), being the European Securities and Markets Authority (ESMA), the European Banking Authority (the EBA) and the European Insurance and Occupational Pension Authority (EIOPA). Therefore, even though the EU regulatory reform programme is now beginning the transition from legislation to implementation, a lot remains on the regulatory agenda into 2015 and beyond (with some measures not due to be implemented until 2025).

We have set out below a summary of some of the main developments during 2014 and the likely key areas of activity during 2015.

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1. EMIR IMPLEMENTATION

The European Market Infrastructure Regulation (EMIR)\(^1\) relating to the regulation of derivatives in the EU came into force in August 2012, but most of the relevant provisions require further delegated acts, RTS and ITS to be put in place before coming effective. That process continued during 2014. Some of the principal developments and expected further action in 2015 are set out below.

*Reporting*

After the commencement of the majority of EMIR’s risk mitigation requirements in 2012, on 12 February 2014\(^2\) we finally saw the introduction of trade reporting, ensuring that all derivatives transactions (whether traded over the counter (OTC) or otherwise) entered into, modified or terminated by European counterparties are required to be reported to a trade repository within certain specified time limits. On 11 August 2014, the reporting regime was further expanded to include the reporting of collateral and valuation information, although this requirement only applies to financial counterparties and non-financial counterparties above the clearing threshold.

Almost immediately after the February reporting requirement became effective, concerns arose as to the ability and readiness of counterparties to provide the information required to complete the pro-forma trade reports. In its relevant ITS\(^3\), ESMA created 85 data fields for counterparty completion but provided minimal guidance on how to generate the required data. These difficulties were also compounded initially by a backlog of applications to the trade repositories, as well as difficulties in obtaining Legal Entity Identifiers (LEIs) (required to help identify a reporting entity and match up trades between counterparties). The reporting process does now appear to have settled down although in a consultation paper published on 10 November 2014\(^4\), ESMA recognises that the “practical implementation of EMIR reporting showed some shortcomings” and as such, recommendations have been made for changes to the relevant RTS\(^5\) and ITS governing the application of the reporting obligation for counterparties and central counterparties (CCPs). Once ESMA’s final report is submitted to the EU Commission, the Commission will have three months to decide whether to endorse ESMA’s proposed changes – it is therefore likely that there will be some technical amendments to the derivatives reporting regime in early 2015.

*Clearing*

As regards the clearing obligation, the implementation progress has been slower. As we reported in our recent article on the clearing of derivatives transactions in the EU\(^6\), between July and October of 2014, a number of consultations and reports have been published by ESMA, setting out the initial classes of derivatives likely to be subject to a clearing obligation. In particular, certain types of interest rate derivatives (fixed to floating rate swaps, floating to floating rate (or basis) swaps, forward rate agreements and overnight index swaps), credit derivatives (trades referencing certain untranched credit indices) and foreign exchange derivatives (non-deliverable forwards) are all likely to be covered.

These reports also provide detail on the likely phase-in schedule with respect to clearing. ESMA’s proposals include sub-dividing market participants into different categories in order to ensure that the largest and most active market participants are required to clear first. In summary, Category 1

---


\(^{2}\) This was the reporting start date for trades entered into (1) on or after 16 August 2012 and still outstanding as of 12 February 2014, or (2) on or after 12 February 2014. For those trades entered into prior to 16 August 2012 that were not outstanding as of 16 August 2012, there is no trade reporting obligation. For those trades entered into either (1) prior to 16 August 2012 that were still outstanding as of 16 August 2012 or (2) on or after 16 August 2012 but in each case where such trade was not outstanding as of 12 February 2014, the trade reporting date is 12 February 2017. For those trades entered into prior to 16 August 2012 that were still outstanding as of 12 February 2014, the trade reporting start date was 13 May 2014.

\(^{3}\) Commission Implementing Regulation (EU) No. 1247/2012


\(^{5}\) Commission Delegated Regulation (EU) No. 148/2013

counterparties will be comprised of clearing members of an authorised CCP. Category 2 and 3 counterparties will include (non-clearing member) financial counterparties and alternative investment funds that trade above the clearing threshold. Category 4 counterparties include all other non-financial counterparties above the clearing threshold.

Given the categorisation of a particular counterparty, it is possible to determine the applicable clearing obligation phase-in date, which is presently proposed to be six months for Category 1 counterparties, 12 months for Category 2, 18 months for Category 3 and three years for Category 4, in each case after the date the applicable RTS governing the clearing of a particular class of derivatives enters into force. When this date might be, however, remains unknown. As with the reporting consultation referred to above, as soon as ESMA submits the RTS proposals for each derivative class to the Commission, the Commission will have three months to decide whether or not to endorse them.

The first RTS in relation to Interest Rate Swaps (the IRS RTS)\(^7\) was sent to the Commission on 1 October 2014. In a letter from the Commission dated 18 December 2014, it was confirmed that it intends to endorse the IRS RTS, subject to certain amendments. As a consequence, ESMA now has a period of six weeks to amend and re-submit the IRS RTS to the Commission. The required amendments have arisen as a result of a lack of certainty in respect of timing. In particular, ESMA had proposed that the frontloading requirement would commence from the date the technical standards are published in the Official Journal of the EU. However, concerns were raised by market participants that this would not allow enough time for Category 1 counterparties to implement the arrangements necessary for frontloading. Further, entities which could potentially fall into either Category 2 or 3 (depending on whether they are above or below a €8 billion threshold for the monthly average of non-centrally cleared derivatives over the three-month period prior to the relevant RTS coming into force) did not know when to begin the monitoring process for such three-month look-back period. As a consequence, the commencement of the frontloading requirement has been delayed for Category 1, until two months after entry into force of the applicable RTS and for Category 2, until five months after entry into force of the applicable RTS.

**Collateral**

In accordance with a requirement to develop technical standards governing the timely, accurate and appropriate segregation of collateral (under Article 11(15) of EMIR), in April 2014, the ESAs published RTS on risk mitigation techniques for the collateralisation of uncleared derivatives transactions\(^8\). At the centre of the ESA’s proposals are requirements to (1) collect variation margin on a daily basis to cover the mark-to-market exposure of counterparties during the life of an existing trade and (2) collect initial margin upon inception of the trade, as calculated either in accordance with a model referred to as the Standardised Method (set out in such RTS) or another initial margin model acceptable to the regulators. Only certain assets may be posted for this purpose and a list of eligibility criteria must be satisfied. Once collected, the margin must be segregated from proprietary assets in the books and records of the custodian or third party that is holding it. Initial margin also cannot be rehypothecated.

Primarily impacting European financial counterparties and non-financial counterparties trading above the clearing threshold, the requirements are somewhat controversial in that they fail to exempt third-country entities trading below the clearing threshold (even though counterparties established in the EU with equivalent “NFC minus” status would be so exempt). Other exemptions are provided, however, including (but not limited to) where the total collateral exchanged between two counterparties at a group level would be equal to or less than €50 million, where trading is with an entity that is exempt from EMIR (such as an EU-based central bank), or where the relevant trade to be collateralised is a physically settled foreign exchange swap or forward.

The collateralisation of uncleared trades will be phased in from 1 December 2015. However, only the largest market participants will be subject to initial margin collection requirements from that date (i.e., only

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those that trade non-centrally cleared derivatives in excess of €3 trillion in monthly aggregate notional amount). Counterparties trading non-centrally cleared derivatives in excess of €8 billion will be subject to the requirements by December 2019.

2. MiFID II IMPLEMENTATION

MiFID II is the overhaul of the Markets in Financial Instruments Directive which originally came into force in 2007. The primary MiFID II legislation comprises a Regulation (MiFIR)9 and recast Directive10 (together with MiFIR referred to as MiFID II). MiFID II was published in the Official Journal of the EU on 12 June 2014 and entered into force 20 days after that date. The provisions will not, however, become effective in the EU until January 2017.

MiFID II significantly expands the scope of the existing MiFID legislation, including:

- some amendments to the investor protection provisions including a narrowing of the execution-only exemption so structured UCITS are now outside the exemption, together with bonds or other forms of securitised debt that incorporate a structure which makes it difficult to understand the risk involved;
- structured deposits are now subject to a number of the provisions of MiFID II;
- the extension of many provisions of MiFID II to “organised trading facilities” or OTFs which will cover many forms of organised trading (not being regulated markets or multilateral trading facilities (MTFs)) of bonds, structured finance products and derivatives;
- requiring all derivatives, that are subject to the clearing obligation under EMIR and that ESMA determines to be sufficiently liquid, to be traded on a regulated market, MTF or OTF;
- extending the pre- and post-trade transparency regime (which currently only applies to shares) to bonds, structured finance instruments and derivatives traded on a trading venue;
- wider product intervention powers granted to ESMA and competent authorities including the ability to temporarily prohibit or restrict marketing of certain products in the EU;
- increased regulation of algorithmic and high-frequency trading;
- significantly expanding the scope of the regulation of commodities and commodity derivatives.

Although the primary legislation is now in place, a significant amount of detail still needs to be drafted. Much of this will be in the form of delegated acts of the EU Commission, mostly comprising regulatory and implementing technical standards to be drafted by ESMA and the other ESAs. In advance of the preparation of this secondary legislation, ESMA published in May 2014 a Consultation Paper11 and a Discussion Paper12 outlining its initial thinking in a number of respects. In addition, in August 2014 the European Banking Authority (EBA) published a consultation paper13 containing draft technical advice to the EU Commission on delegated acts to be published in relation to intervention powers in respect of structured deposits.

On 19 December 2014, ESMA published its final technical advice to the EU Commission\textsuperscript{14} and a second consultation paper on MiFID II\textsuperscript{15} and is likely to spend much of 2015 engaged in the consultation process for MiFID II. It is expected to submit the bulk of the final regulatory technical standards to the EU Commission by the end of 2015 and the final implementing technical standards by 2016. Amongst the areas likely to be of key interest to market participants are ESMA’s proposals as to which derivatives or classes of derivative will be regarded as sufficiently liquid to be subject to the trading obligation under MiFIR and its guidance as to the availability of waivers from the pre-trade transparency requirements for bonds, structured finance instruments and derivatives (with liquidity likely to be the key consideration). In its recent technical advice and consultation paper, ESMA undertakes a detailed consideration of what constitutes a liquid market for the purpose of granting waivers of pre-trade transparency requirements for bonds, structured finance instruments and derivatives. As required by MiFIR, it focuses on average frequency and size of transactions, number and type of market participants, and average size of spreads. It proposes determining liquidity by dividing each asset group into more granular classes that share largely homogeneous liquidity characteristics and then sub-divides such classes further by factors such as maturity, issue sub-type and issue size (for bonds) and derivative type, number of instruments, number of trades and total notional amount (for derivatives). Its conclusions for each sub-class are set out in detailed tables in the technical advice. In relation to determining whether a derivative is sufficiently liquid to be subject to the exchange trading requirement, ESMA considers similar factors and indicates in many cases the thresholds will be the same or very similar as in relation to the test for the transparency rules but this will not necessarily always be the case.

3. BRRD IMPLEMENTATION

The Bank Recovery and Resolution Directive (BRRD)\textsuperscript{16} came into force in July 2014. The majority of the BRRD’s provisions must be implemented into EU member states’ national laws by 1 January 2015. The exceptions to this are the provisions relating to the bail-in tool, which are required to be implemented by 1 January 2016 at the latest. However, the UK Treasury has indicated that it will apply all of the provisions of the BRRD in the UK from 1 January 2015, including the bail-in requirements, with the exception of the minimum requirement for eligible (or bail-inable) liabilities (MREL), and the requirements for instruments governing bail-inable liabilities to contain contractual agreement/acknowledgement by the creditor that the liability could be subject to bail-in.

The BRRD requires EU credit institutions and certain investment firms to prepare recovery plans and for their relevant competent authorities to prepare resolution plans for such institutions based on information and other data provided to the authority by such firms. It also provides a mechanism for co-operation between resolution authorities in applying resolution tools and powers to cross-border groups. The BRRD also gives powers to competent authorities to take certain early intervention measures to seek to prevent a firm from going into resolution and, where a firm does need to be resolved, sets out resolution tools and powers available to authorities, namely the sale of business tool, the bridge institution tool, the asset separation tool and the bail-in tool. Various general principles are to govern the use of such bail-in powers, including that the firm’s shareholders should bear the first loss, following which creditors should then bear losses in accordance with their order of priority, and no creditor should incur greater loss than would have been the case if the firm had been wound up under a normal insolvency.

The bail-in power gives resolution authorities the power to determine when the firm has reached the point of non-viability and enables them to impose losses on certain creditors by writing their claims down or off or converting them into equity. The power is applicable to a wide range of unsecured liabilities of the firm with certain limited exceptions. The BRRD also requires firms to maintain a minimum amount of own funds and “eligible liabilities” (being liabilities that can be bailed-in under the bail-in tool) and referred to as the MREL. The EBA must produce RTS in respect of the criteria to be used by competent authorities for


determining the MREL for individual firms, and it produced a consultation paper setting out draft RTS in this respect in November 2014.\(^\text{17}\)

The EBA’s draft RTS were based in part on recommendations published by the Financial Stability Board (FSB) in November 2014\(^\text{18}\) on the adequacy of the loss-absorbing capacity of global systemically important banks (G-SIBs). The FSB’s proposals include that the minimum total loss-absorbing capital (TLAC, which is broadly equivalent to the MREL) to be held by a G-SIB should be in the region of 16 to 20% and at least twice the Basel III tier 1 leverage ratio requirement.

In relation to the provisions regarding contractual recognition of bail-in, the EBA must develop draft RTS to determine the contents of the required contractual term, and these must be submitted to the EU Commission by 3 July 2015. It produced a consultation paper with draft RTS in this regard in November 2014\(^\text{19}\). The EBA has also produced various other draft RTS required under the BRRD to be delivered to the EU Commission during 2015, and work will continue on finalising these in 2015.

In the UK, we expect to see the Treasury’s proposals on the required levels of MREL in the first half of 2015, in order that these can be implemented by the end of 2015, as required. In the meantime, it is proposed in the draft version of the UK Bank Recovery and Resolution Order 2014\(^\text{20}\), published in November 2014 that, as from 1 January 2015, the Bank of England will be empowered to set a minimum requirement for own funds and eligible liabilities on an institution-by-institution basis. The Prudential Regulation Authority (the PRA) in the UK is currently considering whether the provisions on contractual recognition of the bail-in tool should be implemented with effect from January 2015 for contracts such as regulatory capital and other debt market instruments, and as from January 2016 for all other relevant liabilities. It acknowledges, though, that the publication of the final draft RTS by the EBA by July 2015 may entail some changes to its rules in this regard.

4. SRM IMPLEMENTATION

Closely coupled with the BRRD is the European single resolution mechanism (SRM) established by the SRM Regulation\(^\text{21}\). The SRM applies to all banks that are subject to the Single Supervisory Mechanism (SSM), and the SSM applies to all banks in the Eurozone and in certain other participating member states – around 6,000 of them – and establishes the European Central Bank (the ECB) as the single bank supervisory authority. The SRM further develops the “single rulebook” concept of the SSM. It does this by adopting recovery and resolution mechanisms that essentially mirror those in the BRRD and by establishing a Single Resolution Board (SRB) as the main resolution authority for all banks subject to the SSM. As the UK has opted out of the SSM, banks established in the UK will not be subject to the SRM.

The SRB (which will consist of a member appointed by each SSM member state, as well as an Executive Director, Deputy Executive Director and a member appointed by each of the EU Commission and the ECB) will determine whether the conditions for resolution of an individual bank have been met, and if so will recommend to the EU Commission that the bank be put into resolution, as well as the resolution tools that should be applied, and how the Single Bank Resolution Fund (SBRF) should be used. The EU Commission will then have the final decision as to whether or not to place the bank into resolution and what tools to use.

The SBRF will be funded by bank contributions in a similar way to the national resolution funds under the BRRD, with a similar target fund level and time frame for reaching it.

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In terms of the interaction between the BRRD and the SRM, where a resolution procedure would affect only banks governed by the SSM, then the SRM would apply. Where a resolution procedure would affect only banks outside the scope of the SSM, then the BRRD would apply. Where a resolution procedure would affect both banks within and outside the scope of the SSM, then the BRRD will apply, with the SRB representing the national resolution authorities of the SSM–participating member states.

The majority of the provisions of the SRM Regulation will apply from 1 January 2016. From 1 November 2014, the EU Commission and the EU Council have had the power to adopt delegated and implementing acts, respectively, in relation to contributions to the funding of the SBRF. The SRB became fully operational on 1 January 2015, and the EU Commission is required to publish an evaluation report by 31 December 2018, and every five years after that, on the application of the SRM Regulation.

5. EU BANKING STRUCTURAL REFORM PROPOSALS

January 2014 saw the publication by the EU Commission of a draft Regulation mandating structural separation of certain EU banking activities. This draft Regulation is a culmination of the initiative started by the establishment of a high-level expert group and the resulting Liikanen report in 2012, although this legislative proposal has moved a long way from that original initiative.

The draft Regulation is intended to apply to the largest 30 or so banking groups in the EU, those designated as global systemically important institutions (G-SIIs) under the CRD IV legislation, and will catch EU credit institutions and their parent companies, and branches and subsidiaries of these entities, wherever they are located in the world.

It will also apply to certain non-G-SIIs if they have had, for a period of three consecutive years, total assets of at least €30 billion and trading activities amounting to at least €70 billion or 10% of total assets. This will include the EU branches of US and other non-EU banks and also the non-EU subsidiaries of EU parent companies, unless those branches and subsidiaries are subject to regulations deemed equivalent to those in the EU.

The Regulation will firstly prohibit proprietary trading (defined as using capital or borrowed money to take a position in a financial instrument or commodity for the sole purpose of making a profit for own account (i.e., excluding activities connected to actual or anticipated client activities)) by in-scope entities.

It will also prohibit in-scope entities from investing capital or borrowed money in a hedge fund (or fund-linked instrument) or other entity that engages in proprietary trading or itself invests in hedge funds, again where the sole purpose of the investment is making a profit for own account.

In-scope entities are also subject to the possibility that a national competent authority may force them to separate off one or more of their trading activities where these are considered to pose a threat to the institution’s financial stability or that of the EU financial systems as a whole. “Trading activities” are defined as meaning any activities other than a list of permitted activities, such as taking deposits, lending, payment services, custody and safekeeping services, etc., but specifically included as trading activities are market-making, sponsoring securitisations and trading in derivatives (other than a narrow range of permitted hedging instruments).

The draft Regulation is currently scheduled to be considered by the European Parliament during its plenary session in April 2015, and the Commission intends for the Regulation to be adopted by June 2015 and for the secondary rule-making to be completed by the end of 2015. It intends that a list of in-scope banking groups would be published by 1 July 2016, and annually thereafter. The proprietary trading prohibition is intended to become effective from 1 January 2017, and the provisions on potential separation of trading activities from 1 July 2018. It should, however, be noted that the provisions remain controversial in many member states with many differing views as to how structural reform of banks

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should be effected. There are concerns in some quarters that the proposals are too narrow compared with provisions in other jurisdictions, including the Volcker Rule in the US. Other jurisdictions are concerned as to the effect of the prohibition on proprietary trading on banks in their jurisdiction. The final outcome is therefore far from certain.

6. IMPLEMENTATION OF BANKING REFORM ACT IN THE UK

The UK Financial Services (Banking Reform) Act 2013 (the Banking Reform Act)\(^\text{24}\) enacts a number of changes to the UK banking system, in particular in relation to the requirement to ring-fence retail banking services. As expected, the main provisions as to the excluded activities and prohibitions applying to ring-fenced banks will come into force on 1 January 2019.

As mentioned in relation to the BRRD above, the bail-in stabilisation option under the Banking Act 2009 largely came into force on 31 December 2014. However, the provisions relating to the primary loss-absorbing capacity of ring-fenced banks and UK global systemically important banks have been delayed, as these overlap with the provisions regarding MREL under the BRRD (see above).

The provisions relating to giving preference to depositors, to the extent their deposits are covered by insurance under the Financial Services Compensation Scheme, came into force on 31 December 2014.

The new senior persons regime, licensing regime and banking standards rules all came into force in July 2014. However, the new criminal offence of reckless misconduct in the management of a bank, which will potentially apply to individuals who are covered by the senior persons regime, has not yet had a date announced for its commencement. When this commences, the maximum sentence for individuals found guilty of the offence will be seven years in prison and/or an unlimited fine.

It currently looks likely that ring-fenced banks (broadly, banks engaging in significant non-institutional deposit-taking) will not be permitted to sell structured products or derivatives unless they fall within a specified range of hedging transactions for customers. In addition, it seems that neither their subsidiaries, nor their parent companies, will be able to engage in such activities, and banking groups that contain a ring-fenced bank will need to engage in these activities through “sibling” entities. These proposals are controversial and likely to be subject to further debate into 2015. The ring-fence will not come into force until 2019, but banks are already planning the transition to the new regime.

7. PRIIPS REGULATION

On 9 December 2014, the final text of the EU Regulation on key information documents (KIDs) for packaged retail and insurance-based investment products (PRIIPs) was published in the Official Journal of the EU\(^\text{25}\) and came into force on 29 December 2014. The provisions of the Regulation will not, however, become effective until two years later (so 29 December 2016).

Under the Regulation, when a person is advising on or selling a PRIIP to retail investors, a KID must be provided to the investor prior to any contract being concluded. The primary obligation to draw up the KID will be on the manufacturer of the PRIIP (including any entity that makes significant changes to an existing PRIIP). The Regulation contains detailed requirements as to the form and content of the KID, which must be a maximum of three sides of A4 paper. The KID should be a “stand-alone” document separate from marketing materials and contain key information relating to the product. Although “key information” is not defined, an explanatory statement to be included in the KID will state that the information is intended to help the investor understand the nature, risks, costs and potential gains and losses of the product, and to help comparison with other products.


On 17 November 2014, the ESAs released a joint discussion paper\textsuperscript{26} in relation to the KID. The paper sets out their thoughts as to the presentation and content of each element of the required KID content, the methodology underpinning the presentation of risk and reward, such as the risk indicator and performance scenarios and the methodology for calculation of costs including the specification of summary indicators. The risk and reward section of the discussion paper focuses on issues such as defining risk and reward; defining market, credit and liquidity risk; and the different possible measures and ways of presenting each type of risk. These include various possible presentations of a summary risk indicator in pictorial form. In relation to the costs section, the paper discusses different types of costs and the scenarios in which they can occur in relation to different types of PRIIP. It also explores different possible options for presenting costs, including different visual ways of presenting a summary costs indicator.

The ESAs invite comments to be submitted by 17 February 2015, and they will use the feedback on the discussion paper to prepare draft regulatory technical standards. They expect to publish a consultation on these technical standards in the autumn of 2015. However, before this, there will be a consumer testing exercise organised by the EU Commission to assist the ESAs in developing the standards. It is also expected that a further technical discussion paper on the KID will be published in the first half of 2015.

8. AIFMD

The Alternative Investment Fund Managers Directive (the \textbf{AIFMD})\textsuperscript{27} came into effect in the EU on 22 July 2013 and governs the management and marketing within the EU of alternative investment funds (\textbf{AIFs}) by alternative investment fund managers (\textbf{AIFMs}). The definition of an AIF is very broad, being a collective investment undertaking which is not a UCITS fund but which raises capital from a number of investors, with a view to investing it in accordance with a defined investment policy for the benefit of those investors. However, AIFs categorized as “small AIFs” are exempted from the majority of the provisions of the Directive. An AIFM is defined simply as a legal person whose regular business is the managing of one or more AIFs. Managing an AIF involves performing portfolio management activities and/or risk management activities for an AIF.

The AIFMD creates a harmonised set of rules in the EU for the supervision of AIFMs and requires AIFMs to be authorised and subject to supervision by their home competent authority. It also imposes a capital requirement of at least €125,000 on AIFMs. The AIFMD sets out various requirements as to governance and conduct of business, including rules relating to remuneration policies and practices. AIFMs are also subject to various transparency obligations requiring financial reports and information to be submitted to the relevant competent authority.

There is no requirement for a fund or a manager to be established or based in the EU in order to fall within the remit of the AIFMD. Non-EU AIFMs marketing one or more AIFs to professional investors in an EU country are currently required to comply with that country’s AIFMD implementing legislation irrespective of the domicile of such AIFs. However, such non-EU AIFMs cannot benefit from the AIFMD marketing passport across the EU until the EU Commission implements delegated legislation extending the passporting regime to non-EU AIFMs (following a positive opinion from ESMA). This is expected to be in place by the end of 2015, but until then non-EU AIFMs can only actively market AIFs to professional investors in an EU jurisdiction in accordance with that jurisdiction’s national private placement regime.

After the passporting regime becomes available to non-EU AIFMs, they can either seek authorisation under the AIFMD (and benefit from the pan-European marketing passport) or continue to rely upon those national private placement regimes that continue to exist, although it is currently expected that all national private placement regimes in the EU will be abolished from 2018, subject to an opinion of ESMA.

\textsuperscript{26} \url{http://www.esma.europa.eu/system/files/jc_dp_2014_02_-_priips_discussion_paper.pdf}

2015 is expected to bring about the culmination of the work of ESMA further to its call for evidence in November 2014\(^28\) relating to the functioning of (i) the passport for EU AIFMs managing and marketing EU AIFs under the AIFMD and (ii) the national private placement regimes. This is to consider whether the passport should be extended to the management and marketing of AIFs by non-EU AIFMs and to the marketing of non-EU AIFs by EU AIFMs. ESMA is due to provide an opinion and advice to the European Parliament, the Council and the Commission in July 2015, and in October 2015 the Commission will, subject to a positive ESMA opinion, adopt a delegated act to specify when such passport will become available. In addition in 2015, ESMA will continue its consultation in relation to asset segregation by depositaries holding assets for AIFMs.\(^29\)

9. SHADOW BANKING REFORMS

The “shadow banking” sector continues to be an area of key regulatory focus. This has been spearheaded at international level by the FSB following a mandate at the G20 leaders’ meeting in St. Petersburg in November 2010. The FSB has avoided giving a specific definition of shadow banking but has focused on non-bank intermediation which it regards as credit intermediation involving entities and activities fully or partially outside the regular banking system. The FSB has stressed that any definition by national regulators should be capable of adapting with changes and developments in the financial markets.\(^30\)

The FSB’s work has focused on five workstreams: (a) interaction of the regular banking system with shadow banking, (b) the regulation of shadow banking entities, (c) securitisation and excess leverage, (d) regulation of securities lending and repos and (e) money market regulation. It has, together with the International Organization of Securities Commissions (IOSCO) in some cases, published a number of reports and policy recommendations covering these areas.

In the EU, the EU Commission in its March 2012 Green Paper\(^31\) on shadow banking approved the FSB’s general definition of shadow banking and sought to give a non-exhaustive indication of the types of entities and activities that it believes fall within the scope of shadow banking. Activities comprise primarily securitisation and securities lending and repos. Entities include SPVs (such as ABCP conduits) performing liquidity and/or maturity transformation, money market funds, leveraged investment funds (including ETFs) and finance companies and insurance/reinsurance undertakings issuing or guaranteeing credit products. It subsequently published a Communication on shadow banking in September 2013\(^32\) setting out more detail on priority areas where it believes further work and legislation is needed.

The existing regulatory reform programme in the EU has already led to many of the proposals from the FSB workstreams being implemented in the EU. CRD IV (and previous amendments to the Capital Requirements Directive) has implemented Basel III including increased capital requirements for banks’ exposures to resecuritisations and liquidity facilities provided to securitisation vehicles and enhanced disclosure requirements. As described above, the AIFMD has imposed a harmonised EU regulatory regime for alternative investment funds. EMIR has also imposed a comprehensive reporting regime for OTC derivatives. Two areas where there is ongoing work in the EU, which will continue into 2015, are the regulation of securities financing transactions and money market funds. The current status of each is as follows:

(a) Securities Financing Transactions: Although the securities lending and repo markets are vital in meeting many financial institutions’ financing needs, supporting market liquidity and facilitating market-making, the FSB believes that many transactions are entered into by non-banks, giving rise to maturity and liquidity transformation risks. Concerns raised by the FSB include potential build-up of leverage, liquidity risks, the extent of reinvestment of cash collateral, potential pro-cyclicality due to the relationship

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between funding levels and fluctuating asset values and volatility caused by valuation haircuts and risks relating to rehypothecation of collateral. It has developed 11 policy recommendations including minimum regulatory standards for cash collateral reinvestment and new regulatory requirements relating to rehypothecation including sufficient disclosure to enable clients to understand their potential exposure in the event of a failure of the intermediary. In October 2014 the FSB published a Regulatory Framework for haircuts on non-centrally cleared securities financing transactions including proposed numerical floors for haircuts.

In January 2014, the EU Commission published a draft Regulation on reporting and transparency of securities financing transactions which focuses on transparency, disclosure and rules relating to rehypothecation. The draft Regulation provides for EU entities (whether or not financial entities) to report details of securities financing transactions to a trade repository similar to the reporting requirements for OTC derivatives under EMIR. For these purposes, the definition of securities financing transactions is wide and includes repos, reverse repos, securities borrowing and lending transactions and equivalent financing structures. The draft also contains additional disclosure requirements for managers of UCITS funds and alternative investment funds including criteria for counterparties and collateral and valuation methodologies and details of rehypothecation policies. In relation to rehypothecation, the draft Regulation proposes that the client or counterparty must consent in writing to an asset being rehypothecated, the risks of rehypothecation must be explained in writing to the collateral provider and assets received as collateral must be transferred to an account in the name of the receiving counterparty.

The EU Council recently announced that it has agreed its negotiating position in relation to the draft Regulation, and discussions between the EU Commission, EU Parliament and EU Council are expected to progress in the early part of 2015. It is therefore possible that the Regulation may be adopted at some time during 2015.

(b) **Money Market Funds:** The FSB has acknowledged that MMFs are an important source of credit and short-term funding for the regular banking system and provide maturity transformation and leverage. It also expressed concern, however, that some MMFs suffered large losses during the financial crisis, often due to ABS holdings, leading to significant redemptions, runs and subsequent bail-outs for some funds. IOSCO has driven much of the work on this workstream and published a final report in October 2012 setting out 15 policy recommendations for a common approach in relation to MMF regulation, including that MMFs offering a stable NAV should be subject to measures designed to reduce specific risks related to this feature. Other recommendations included a requirement for fair value principles for portfolio valuations and requirements for MMFs to hold a minimum amount of liquid assets to meet redemptions.

The EU Commission published a draft Regulation relating to money market funds in September 2012. This draft contains provisions limiting investments by MMFs to certain low-risk investments, including money market instruments with high internal credit ratings and deposits with eligible credit institutions with a maximum maturity of 12 months. It also proposes stricter diversification and concentration limits. The draft Regulation does not seek to abolish constant NAV MMFs but proposes they be subject to a capital buffer of at least 3% of total assets. Concerns have been raised that this buffer may make such funds uneconomical. It also proposes minimum average maturity and weighted average life requirements and a prohibition on external credit ratings.

The draft Regulation differs in a number of important respects from the approach taken by the SEC in the US in adopting new rules for MMFs which came into force in October 2014. The new SEC rules impose a floating NAV requirement for non-retail and non-governmental MMFs. The draft Regulation also provides

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for liquidity fees and gates to be imposed in certain circumstances where the fund’s board determines it is in the fund’s best interests to do so.

As we move into 2015, there is likely to be considerable activity in the EU to seek to reach agreement on the draft MMF Regulation referred to above, and it will be interesting to see if the proposals move closer to the SEC position as the Regulation goes through the EU legislative process. The EU Council of Ministers has proposed a compromise draft which would bring the Regulation more in line with the new SEC rules, including eliminating the proposed buffer for retail and small professional constant NAV funds and requiring the board of such funds to consider imposing redemption gates and fees when the proportion of weekly maturing assets falls below 30% of net assets. The draft report of the European Parliament’s Committee on Economic and Monetary Affairs (ECON) also proposes amendments to the Regulation, although it takes a different approach to the EU Council. In relation to constant NAV funds, ECON is still exploring various options, including (i) maintaining the proposed capital buffer, (ii) developing a system based on liquidity fees and redemption gates, (iii) developing a European variation on the SEC rules with a carve-out for governmental MMFs or (iv) developing a system of low-volatility NAV funds. Negotiations are likely to continue through 2015, and it remains to be seen if political agreement can be reached to enable the Regulation to be finalised in the coming year.

10. BENCHMARK REGULATION

The use of benchmarks in financial transactions has been the subject of focus from international regulators in recent years following investigations of a number of financial institutions for alleged misconduct in relation to the setting of LIBOR as well as other financial benchmarks. In the UK, following a review by Martin Wheatley, CEO of the Financial Conduct Authority, a number of reforms have been made in relation to the setting of LIBOR in the Banking Reform Act 2013. In September 2014, following a review by the Bank of England, HM Treasury published a consultation paper recommending that additional financial benchmarks be subject to regulation in the UK. In December 2014, HM Treasury confirmed that the UK government would implement the recommendations in respect of seven benchmarks. At the same time, the FCA published a consultation paper on bringing additional financial benchmarks under its supervision. On a global level, IOSCO published principles for financial benchmarks in July 2013 which have been endorsed by the FSB and the G20 setting out a framework of standards in relation to issues of governance, benchmark quality and calculation methodology.

In September 2013, the EU Commission published a draft Regulation in relation to indices used as benchmarks in financial instruments and contracts with the stated aim of improving the governance and controls applicable to financial benchmarks (and in particular the avoidance or appropriate management of conflicts of interest), the quality of data used in setting the benchmark and methodologies used by benchmark administrators and ensuring that contributors to benchmarks are subject to adequate controls. The draft Regulation imposes various obligations on benchmark administrators, contributors and users. Benchmark administrators located in the EU will be subject to authorisation and supervision by their competent authorities including detailed governance requirements. A benchmark administrator will also be required to ensure that the input data is sufficient to represent accurately and reliably the market or economic reality that the benchmark is intended to measure and is responsible for ensuring that there are adequate and effective systems and controls to ensure the integrity of input data and to put appropriate monitoring in place. The administrator is also required to publish relevant input data immediately after publication of the benchmark, although it may delay publication where there would otherwise be serious adverse consequences for the contributors or if immediate publication would adversely affect the reliability or integrity of the benchmark.

References:
In relation to benchmark users, an entity that is subject to supervision in the EU will only be permitted to issue or own a financial instrument or be party to a financial contract which references a benchmark or use a benchmark that measures the performance of an investment fund if the benchmark is provided by an administrator authorised under the Regulation or is an administrator located outside the EU that is registered by ESMA subject to specified criteria.

Having regard to the systemic importance of certain benchmarks, the EU Commission will be required to maintain a list of critical benchmarks. If at least 20% of the contributors to a critical benchmark cease or are likely to cease to make contributions, the relevant competent authority has the power to take various actions, including requiring selected supervised entities to contribute input data; determining the form in which and the time by which any input data must be contributed; and changing the code of conduct, methodology or other rules of such benchmark.

The draft Regulation is still going through the EU legislative process. ECON largely welcomed the draft Regulation but expressed concerns as to the breadth of the scope of the definition of “index”, suggesting that the scope be narrowed to benchmarks in certain specified categories of financial index. It also recommended that national competent authorities be given more powers to ensure mandatory contributions to critical benchmarks and further consideration be given to the treatment of benchmarks administered outside the EU - many benchmarks used in financial instruments, including derivatives, originate from outside the EU and it would cause considerable disruption to financial markets if many of these could not continue to be used. The EU Council has also published compromise drafts of the Regulation. Discussions will continue into 2015 and there are likely to be considerable efforts to have the text of the Regulation agreed and finalised during 2015.

11. CRD IV IMPLEMENTATION

The Basel III reforms, in the form of the new Capital Requirements Regulation (CRR) and the CRD IV Directive (and, together with the CRR referred to as CRD IV), largely came into effect on 1 January 2014 in Europe. This included the revised requirements in relation to minimum capital requirements for firms and the introduction of new capital buffers. These requirements are now being phased in in accordance with the terms of CRD IV. CRD IV also provides for a significant number of RTS and ITS to be drafted, principally by the EBA. This process is now well underway, with many of these already having been adopted by the EU Commission through delegated acts.

Certain provisions of CRD IV were always intended to take effect at a later date. In particular, the Liquidity Coverage Ratio (LCR) provisions are to become effective from 2015. The EU Commission in October 2014, adopted a delegated Regulation in relation to the LCR, containing detailed provisions for the ratio. The delegated Regulation generally followed the Basel III LCR standard, with certain amendments, including in relation to giving certain covered bonds extensive recognition and also including, as part of the permitted liquid assets, certain types of securitised asset, such as securities backed by auto loans. The LCR is to be phased in from 1 October 2015, commencing at 60% of the full requirement and rising to 100% of the full requirement by 2018.

The CRR provides for the European Banking Authority to report to the EU Commission by 31 December 2015 on whether the Net Stable Funding Ratio (NSFR) prescribed by Basel III should be introduced and on appropriate methodologies and definitions for calculating the ratio. The EU Commission is required by 31 December 2016, if appropriate, to submit a legislative proposal to the European Parliament and the Council, with the aim of the NSFR applying, if at all, by 1 January 2018.

The other major part of the CRD IV package which has not yet entered into force is in relation to the leverage ratio. The ratio, which is a measure of a firm’s Tier 1 capital, compared to the non-risk weighted values of its assets, is required to be disclosed publicly by each firm as from 1 January 2015. In October

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2014, the EU Commission adopted a delegated Regulation\(^{46}\) making changes to the calculation of the leverage ratio by amendments to the capital measure and the total exposure measure. These included provisions to address the treatment of the exposure values of derivatives and securities financing transactions. By the end of December 2016, the EU Commission is required to submit a report on the impact and the effectiveness of the leverage ratio, and this will be accompanied by a legislative proposal, introducing the leverage ratio as a binding measure, if the EU Commission decides this is appropriate. The binding leverage ratio is intended to be applicable from 1 January 2018 onwards.

An area of CRD IV that has been controversial is that concerning provisions relating to firms' remuneration policies and, in particular, the requirement that a person’s variable remuneration should not exceed the amount of fixed remuneration (with the possibility of it being 200% of fixed remuneration only with shareholder approval (66% majority required with a minimum quorum of 50%)). Variable remuneration must also be subject to clawback arrangements. The UK launched a legal challenge to the cap on variable remuneration on the grounds that it fell outside the powers of the EU. However, following an adverse opinion from the advocate general of the European Court of Justice, the UK abandoned its challenge in 2014. The “bonus cap”, as it has been referred to, will therefore continue to be applicable into 2015. Concern was raised by the EBA and the EU Commission during 2014 as to the practice by some firms of redesignating some variable pay into allowances. Their view was that in many cases, the allowances would still be regarded as variable pay. In October 2014, the EBA published an opinion\(^{47}\) outlining what sort of pay structures it would consider to be variable pay. However, the paper has no binding force in the EU, and it is therefore possible that some firms could press ahead with allowance-type arrangements, leaving open the possibility of competent authorities seeking to impose sanctions and possible future legal action in this area.

12. FINANCIAL TRANSACTIONS TAX

Initially based on a set of failed EU-wide proposals in relation to a tax on financial transactions (the **FTT**) dating back to September 2011, the current revised proposals for the FTT\(^{48}\) are now intended to be applied in just 11 member states\(^{49}\) (the **FTT Zone**) based on a principle of enhanced cooperation which allows a subset of member states that wish to continue to work more closely together to do so, while respecting the legal framework of the Union. In short summary, the purpose of the FTT is to harmonise legislation on the indirect taxation of financial transactions. Specifically, proposals are to impose a tax of 0.1% on all transactions relating to financial instruments other than derivatives (such as options, futures, contracts for difference or interest rate swaps), which will attract a tax rate of 0.01% on the notional amount of the transaction. Under the proposals a tax would be imposed, broadly, where at least one party to a transaction was a financial institution in a participating member state. However, it also sought to impose the FTT on transactions relating to an instrument issued by an entity incorporated or registered in a participating member state even if the parties to the transaction were both outside the FTT zone (e.g. a put option between UK and US banks over shares in a French entity would be potentially subject to the FTT – referred to as the “issuance principle”).

Opting to remain firmly outside of the FTT Zone, the UK has argued strongly that the implementation of the FTT would, when coupled with existing EU tax legislation on mutual assistance and administrative cooperation, result in negative extraterritorial effects for itself and other non-participating states. In April 2014, the UK lost its legal challenge in the European Court of Justice to the granting of authorisation to use enhanced cooperation. While clearly a blow to the UK’s attempt to stop the revised FTT proposals in their tracks, it should be understood that the UK was not (at that stage) taking steps to challenge the implementing measures which will ultimately be adopted by the FTT Zone states. Whether it does so in the future remains to be seen.

\(^{49}\) Belgium, Germany, Estonia, Greece, Spain, France, Italy, Austria, Portugal, Slovenia and Slovakia.
On 31 October 2014, the Italian Presidency of the EU published a report on the status of the revised FTT proposals. The report confirms that efforts have continued to clarify two “key open issues”, being (i) the need to define the scope of the transactions which shall form part of the “first phase” of implementation and (ii) the basic “principle of taxation” that should apply to the levy of the FTT and distribution of income across the FTT Zone. In respect of the scope of transactions, it is stated that most participating member states are in favour of taxing transactions in derivatives linked to an underlying that itself falls under the scope of the FTT (e.g. equity derivatives, where transactions relating to the underlying shares will be within the scope of the FTT). As regards the principal of taxation, it is suggested that either a “residence” or an “issuance” principle shall apply (or some combination of the two), meaning that it is yet to be decided whether the appropriate taxing authority should be (a) that of the place of establishment of the parties to the taxable transaction (residence) or (b) that of the place of the establishment of the issuer (issuance) or both.

In a press release of the European Council on 7 November 2014, it is stated that work shall be intensified in order to enable an agreement in the near future, with the aim of implementing the first phase of the FTT by 1 January 2016. Given the relatively limited amount of detail currently available and the possibility of another legal challenge from the UK, we are likely to see plenty of further activity on the proposed FTT during 2015.

13. MAD IMPLEMENTATION

On 16 April 2014, the revamped legislative package governing market abuse, consisting of the Market Abuse Regulation (MAR) and the Criminal Sanctions for Market Abuse Directive (CSMAD), was formally adopted by the Council of the European Union. As a result of the UK’s special position under the Lisbon Treaty, it has powers to opt out of measures governing EU criminal law and as such has not signed up to CSMAD. MAR, however, will apply automatically in all EU states (including the UK) when it becomes effective in July 2016.

The principal changes that will be brought into effect under MAR include an extension of scope to cover a significantly broader range of securities than are presently covered under the existing Market Abuse Directive (MAD). MAD regulates derivatives traded on the EU’s primary investment exchanges (known as regulated markets). However, in order to take account of the significant amount of off-market trading, MAR will also cover instruments traded on MTFs and OTFs as well as OTC transactions. Commodity derivatives (and related spot commodity contracts), emission allowances and benchmarks will also receive greater regulatory coverage.

Other changes brought about by the introduction of MAR include the regulation of market soundings (discussions with investors, prior to commencement of an actual transaction, to gauge their interest and determine pricing), a new offence of attempted insider dealing and market manipulation, and the prohibition of algorithmic or high-frequency trading strategies where they are used to manipulate markets. The initial proposals to expand the scope of inside information to cover that which a reasonable investor would be likely to consider as part of the basis of his/her investment decision, was not retained in the adopted version of MAR.

On 15 July 2014, ESMA initiated the consultation process for preparing RTS and ITS in relation to MAR. These technical standards will cover a variety of areas, including (amongst other things) (i) the conditions that buy-back programmes and stabilisation measures must meet (such as conditions for trading, restrictions regarding time and volume and disclosure and reporting obligations); (ii) appropriate

55 See Article 7 (Inside information) of the April 2014 text of MAR.
arrangements, procedures and record-keeping requirements for persons to comply with the new market soundings requirements; and (iii) appropriate public disclosure of inside information (as well as rules governing any necessary delay). The deadline for responses to the consultation closed on 14 October 2014. ESMA has indicated that it will finalise the technical standards for submission to the Commission no later than 12 months after the entry into force of MAR\textsuperscript{57} (i.e., by July 2015). In the coming year, we therefore expect to see continued development of ESMA’s technical proposals as we head closer towards implementation in 2016.

14. UCITS V / VI

The UCITS V Directive was published in the Official Journal of the EU on 28 August 2014\textsuperscript{58} and makes various changes to the existing UCITS Directive (UCITS IV)\textsuperscript{59}. It came into force on 17 September 2014, and EU member states have until 18 March 2016 to transpose it into their national laws. The principal amendments made by UCITS V seek to make some of the rules for UCITS funds more consistent with those applicable to alternative investment funds under the AIFMD and include:

- changes to the provisions relating to the appointment of a depositary in respect of a UCITS fund, including new rules relating to duties of oversight, cash monitoring, custody duties and conflicts management;
- rules setting out the terms on which the depositaries’ safekeeping duties can be delegated;
- revision of eligibility criteria for depositaries so only credit institutions and investment firms will be able to act as depositaries;
- clarification of scope of a depositary’s liability in the event of losses relating to an asset held by the depositary;
- the requirement that UCITS management companies put in place remuneration policies and practices for senior management and persons whose professional activities have a material impact on the risk profile of the management company or the UCITS; the policies and practices must be consistent with, and promote, sound and effective risk management and discourage disproportionate risk taking;
- imposition of minimum harmonisation rules to seek to provide more consistency in sanctions provisions in member states.

UCITS V requires the EU Commission to publish and implement various delegated acts and technical standards and guidance. In particular, the EU Commission has to set out various requirements as to the rules relating to depositaries. ESMA published a consultation paper in September 2014\textsuperscript{60} in relation to such delegated acts, focusing on insolvency protection of the assets of a UCITS, where the depositary has delegated safekeeping duties to a third party and the requirements on the management company and depositary to act independently. Following the end of the consultation process, ESMA’s final technical advice was published in November 2014. The EU Commission is likely to publish the delegated acts based on this advice during 2015.

In July 2012, the EU Commission published a consultation paper seeking views on possible further changes to the UCITS regime – such possible changes have been generally referred to as UCITS VI. The Commission did not make specific proposals but outlined possible areas to be covered by further legislation, including eligible assets and the use of derivatives, efficient portfolio management techniques,
extraordinary liquidity management rules, the possibility of a depositary passport, money market funds and long-term investments.

In November 2014, Steven Maijoor, the chairman of ESMA, indicated that many of the major issues that could have been the subject of specific UCITS VI legislation have been or are in the process of being dealt with in other legislation, including the draft Regulation on money market funds and the draft Regulation on European long-term investment funds (ELTIFs)\(^6\). It therefore currently seems unlikely that the EU Commission will make any further proposals for amendment of the UCITS regime during 2015.

15. CENTRAL SECURITIES DEPOSITARIES REGULATION

The Central Securities Depositaries Regulation (CSDR) came into force on 17 September 2014\(^6\) and imposes a new regulatory regime on central securities depositaries and securities settlement in the EU. Provisions requiring the recording of securities in book-entry form, where the trade takes place on a regulated venue, and general requirements to settle transactions in specified financial instruments on the intended settlement date are already in force. Provisions requiring transactions in securities to be executed on trading venues not later than the second business day after the trade is executed apply from 1 January 2015. Other provisions requiring EU issuers to arrange for specified securities to be represented in book-entry form do not come fully into force until 1 January 2025. ESMA is required to draft various technical standards and guidelines under the CSDR and to deliver the draft technical standards to the EU Commission by 18 June 2015. In March 2014 ESMA published a Discussion Paper setting out draft proposals in relation to most of the required RTS and ITS\(^6\).

16. PAYMENT SERVICES DIRECTIVE

The Payment Services Directive (PSD) became law in most of the EU in 2009 and aimed to harmonise the regulatory regime for payment services across the EU by enabling a new type of regulated financial institution (a payment institution) to compete with banks in the provision of payment services. It established an EU-wide licensing regime for payment institutions, as well as harmonised conduct of business rules. In July 2013, the EU Commission published a draft Directive which amends the PSD and other relevant EU legislation (referred to as PSD2)\(^6\). The draft Directive will update the existing framework relating to payment services and expand the scope of regulated payment institutions. New transparency requirements will also apply.

PSD2 will expand the scope of the current Directive by also applying certain provisions when only one payment service provider in a transaction is located in the EU. PSD2 will also now apply the provisions relating to transparency and information requirements to all currencies, not only EU currencies, as is currently the case. The definition of payment services will also be widened to cover services provided in the form of payment initiation services or account information services. A number of the existing exemptions available under the PSD are narrowed or removed, and various amendments are made to the conduct of business requirements.

The EU Council has proposed compromise drafts of the draft PSD2 Regulation, and the EU Parliament has also proposed amendments. Negotiations will continue into 2015. If PSD comes into law, it will be required to be transposed into national law in EU member states within two years of its coming into force.

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AUTHORS

Peter Green
London
+44 (20) 79204013
pgreen@mofo.com

Jeremy Jennings-Mares
London
+44 (20) 79204072
jjenningsmares@mofo.com

Nimesh Christie
London
+44 (20) 79204175
nchristie@mofo.com

Lewis Lee
London
+44 (20) 79204071
lewislee@mofo.com

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Because of the generality of this update, the information provided herein may not be applicable in all situations and should not be acted upon without specific legal advice based on particular situations.
In a flurry of regulatory actions on October 21 and 22, 2014, the Federal Deposit Insurance Corporation (the “FDIC”), the Office of the Comptroller of the Currency, the Federal Reserve Board, the Securities and Exchange Commission, the Federal Housing Finance Agency (the “FHFA”), and the Department of Housing and Urban Development (collectively, the “Joint Regulators”) each adopted a final rule (the “Final Rule”) implementing the credit risk retention requirements of section 941 of the Dodd-Frank Act for asset-backed securities (“ABS”). The section 941 requirements were intended to ensure that securitizers generally have “skin in the game” with respect to securitized loans and other assets.

The risk retention rules were initially proposed by the Joint Regulators in March 2011 (the “Original Proposal”) and re-proposed in August 2013 (the “Re-Proposal”). The Final Rule will become effective one year from the date of publication in the Federal Register for residential mortgage-backed securities (“RMBS”) and two years from the date of publication in the Federal Register for all other ABS. The Final Rule generally tracks the requirements of the Re-Proposal with minor changes made to address comments submitted or to clarify meaning.

Following is an overview of the key provisions of the Final Rule:

**Basic Risk Retention Requirement**

As required by the Dodd-Frank Act, the Final Rule generally requires “sponsors” of both public and private securitization transactions to retain not less than 5 percent of the credit risk of the assets collateralizing any ABS issuance. “Sponsor” is defined in the Final Rule as “a person who organizes and initiates a securitization transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuing entity.” The Final Rule provides that the credit risk required to be retained and held by a sponsor or any other person under the Rule may be acquired and held by any of such person’s majority-owned affiliates, other than the issuing entity. If there is more than one sponsor of a securitization transaction, it is the responsibility of each sponsor to ensure that at least one of the sponsors (or at least one of their majority-owned affiliates, as applicable) retains the required credit risk.

**Standard Risk Retention Methods**

The Final Rule generally permits risk retention to be accomplished through one or a combination of methods: an eligible vertical interest, an eligible horizontal residual interest (“EHRI”), or some combination of the two (an “L-shaped interest”). The percentage of the vertical, horizontal, or L-shaped interest to be retained by the sponsor must be determined as of the closing date of the securitization transaction. Horizontal risk retention may be accomplished by holding ABS issued in the transaction or by establishing a cash reserve account for the
Notably, the Final Rule does not include as a standard risk retention method the “representative sample” method included in the Original Proposal but removed in the Re-Proposal. This method would have permitted a sponsor to satisfy its risk retention obligation by holding, outside of the issuing entity, assets substantially similar to those transferred to an issuing entity in the amount of 5 percent of the assets transferred to the issuing entity. Many commenters on the Re-Proposal urged that this option be restored in the Final Rule, but the Joint Regulators nonetheless declined to adopt this method. Similarly, the Joint Regulators declined to provide options for sponsors to satisfy risk retention requirements by retaining a participation interest in assets transferred to the issuing entity, by providing unfunded credit support such as a guaranty, or through overcollateralization (with limited exceptions).

It should be noted that the Joint Regulators’ decision not to permit the retention of a “representative sample” as a risk retention method also impacts another, existing securitization regulation. Specifically, in 2010, the FDIC substantially amended its rule for securitizations (set forth at 12 C.F.R. § 360.6) that sets forth the conditions under which the FDIC will provide a “safe harbor” to investors by agreeing not to repudiate certain contracts or reclaim assets in connection with certain securitizations by insured financial institutions. This FDIC securitization rule in some circumstances requires insured depository institutions to retain credit risk in connection with their securitizations, and specifically permits the retention of a “representative sample” of assets of the same type as those securitized. The FDIC securitization rule also contains, however, an “auto-conform” provision to the effect that the risk retention provisions of the securitization rule will be automatically conformed to those ultimately adopted by the Joint Regulators pursuant to Section 941 of the Dodd-Frank Act. Accordingly, insured institutions will no longer be permitted to rely on the “representative sample” retention method in order to avail themselves of the FDIC’s securitization safe harbor.

Eligible vertical interest

An “eligible vertical interest” must constitute either (i) a single vertical security entitling the sponsor to the same percentage of amounts paid on each class of ABS interests, or (ii) an interest in each class of ABS interests constituting the same proportion of each class of ABS interests.

The Final Rule eliminated the requirement included in the Re-Proposal that an eligible vertical interest be valued using the “fair value” concept applicable to horizontal interest. Accordingly, a sponsor using the eligible vertical interest approach may in effect value the retained interest at par for purposes of the Final Rule.

Eligible horizontal residual interest

An “eligible horizontal residual interest,” or “EHRI,” is an ABS interest in a single class or multiple classes in the issuing entity that represent the most subordinated claim to payments of principal and interest by the issuing entity (with the exception of any non-economic REMIC residual interest, which is not considered an “ABS interest”). An EHRI’s terms must provide that, if the issuing entity has insufficient funds to satisfy its obligation to pay all contractual interest or principal due, any resulting shortfall will reduce amounts payable to the EHRI prior to any reduction in amounts payable to any other ABS interest. Notably, the Final Rule eliminates a provision of the Re-Proposal that would have restricted the payment of cash flow to the EHRI in order to limit how quickly the sponsor could recover in cash the fair value of the interest.

A sponsor utilizing an EHRI to satisfy risk retention requirements must retain an EHRI having a “fair value” (as determined in accordance with GAAP methodologies) of at least 5 percent of the fair value of all ABS interests issued in the transaction. The Final Rule contains extensive requirements for disclosure by the sponsor of its methodology for determining the fair value of the EHRI and of all ABS interests issued.
A reasonable period of time prior to the sale of the ABS, the sponsor must disclose:

- the fair value of all ABS interests to be issued,
- if the fair values of the specific prices, sizes, or rates of interest of each class are not available, a range, and the method to determine the range, of fair values of all ABS interests issued,
- the material terms of the EHRI, and
- a description of the methodology used to calculate fair values, including a description of key inputs and assumptions.

A reasonable time after the closing of the transaction, the sponsor must disclose, based on the actual sale prices and finalized class sizes of the ABS interests:

- the actual fair value of the retained EHRI at closing,
- the amount the sponsor was required to retain at closing under the Final Rule, and
- any material differences between the actual valuation methodology or inputs and assumptions used from those used for the pre-sale disclosures.

The Final Rule provides sponsors with the option, in lieu of retaining all or any part of an EHRI, to establish and fund, in cash, an “eligible horizontal cash reserve account,” or EHCRA, in the amount equal to the required fair value of an EHRI. Amounts in the EHCRA are to be used to satisfy payments on ABS interests in the issuing entity on any payment date on which the issuing entity has insufficient funds to satisfy an amount due on any ABS interest, or to pay critical expenses of the trust unrelated to credit risk on any payment date on which the issuing entity has insufficient funds to pay such expenses. The EHCRA must be held by the trustee until all ABS interests are paid in full.

**L-shaped interest**

If a sponsor opts to retain both an eligible vertical interest and an EHRI as its required risk retention, the percentage of the fair value of the EHRI and the percentage of the eligible vertical interest must equal at least 5 percent. These percentages must be determined as of the closing date of the securitization transaction.

**Special Risk Retention Methods**

In addition to the standard risk retention methods, the Final Rule includes special risk retention provisions for various specific asset types of transactions. These are described below.

**Revolving pool securitizations**

The Final Rule contains special rules for risk retention by sponsors of “reversing pool securitizations,” a structure often referred to in industry parlance as the “master trust” structure (whether or not the issuing entity is actually a trust). This structure is widely used for securitizations of credit card receivables and other revolving assets. The Final Rule defines a “reversing pool securitization” as “an issuing entity that is established to issue on multiple issuance dates more than one series, class, subclass, or tranche of asset-backed securities that are collateralized by a common pool of securitized assets that will change in composition over time, and that does not monetize excess interest and fees from its securitized assets.”
The Final Rule permits sponsors of revolving pool securitizations to satisfy their risk retention requirement by maintaining a “seller’s interest” of not less than 5 percent of the aggregate unpaid principal balance of all outstanding investor ABS interests in the issuing entity. The Final Rule defines a “seller’s interest” as an ABS interest or ABS interests:

- that is collateralized by the securitized assets and servicing assets owned or held by the issuing entity, with certain exceptions,
- that is pari passu with each series of investor ABS interests issued, or partially or fully subordinated to one or more series in identical or varying amounts, with respect to the allocation of all distributions and losses, and
- that adjusts for fluctuations in the outstanding principal balance of the securitized assets in the pool.

The Final Rule also permits sponsors of revolving pool securitizations to satisfy risk retention requirements by retaining a horizontal subordinated interest in the pool, with some modifications to the standard requirements for an EHRI to accommodate common features of revolving securitizations. A sponsor may also combine a seller’s interest with such an eligible horizontal residual interest to satisfy the 5 percent risk retention requirement.

Eligible ABCP Conduits

For issuers of asset-backed commercial paper (“ABCP”), the Final Rule provides “eligible ABCP conduits” with an option to satisfy risk retention requirements in lieu of using a standard risk retention option. The requirements to qualify as an “eligible ABCP conduit” are complex, and beyond the scope of this overview. Generally, however, the assets of an eligible ABCP conduit must be ABS interests, and must be issued by one or more intermediate special purpose vehicles (“SPVs”). Perhaps most importantly, the eligible ABCP conduit risk retention option requires that an originator-seller of assets to the intermediate SPV retain the requisite 5 percent credit risk exposure, and that a regulated liquidity provider (as defined) has entered into a legally binding commitment to provide 100 percent liquidity coverage to all ABCP issued by the ABCP issuer by lending to, purchasing ABCP issued by, or purchasing assets from, the ABCP conduit in the event that funds are required to repay maturing ABCP issued by the ABCP conduit. The eligible ABCP conduit must also comply with extensive disclosure requirements in order to avail itself of this risk retention option.

Commercial MBS

As in the Re-Proposition, CMBS issuers will have the option of satisfying risk retention requirements by transferring up to two pari passu EHRIs, or “B-pieces,” to third-party purchasers (“B-Piece Buyers”). A B-Piece Buyer must perform its own due diligence of the underlying commercial mortgage loans, and may be affiliated with the special servicer. The B-Piece option may be used to satisfy the entire risk retention requirement, or may be used in combination with the retention of a vertical interest by the sponsor.

The Final Rule requires that an operating advisor be appointed for any securitization in which the sponsor uses the B-Piece option. The operating advisor is required to act in the best interest of, and for the benefit of, all investors. The operating advisor’s purpose is to consult with special servicers on major decisions after the unpaid principal balance of B-Pieces held by third parties is reduced to 25 percent or less of the original principal balance of such B-Pieces, taking into account appraisal reductions and realized losses.

The Final Rule allows transfers of the B-Piece after five years from the closing date of the securitization, whether the B-Piece was retained by the sponsor or by a B-Piece Buyer, provided that the transferee satisfies the requirements applicable to B-Piece Buyers generally. The Final Rule also added a clarification that the risk
retention obligation for CMBS terminates once all of the mortgage loans in a CMBS transaction have been fully defeased.

**Fannie Mae and Freddie Mac ABS**

The Final Rule exempts Fannie Mae and Freddie Mac from the risk retention requirement if such entity fully guarantees the timely payment of principal and interest on all ABS interests issued by the issuing entity in the securitization transaction, for so long as Fannie Mae or Freddie Mac, as applicable, is operating under the conservatorship or receivership of the FHFA with capital support from the U.S. Government. This exemption will also apply to any limited-life regulated entity succeeding to the charter of either Fannie Mae or Freddie Mac, provided that the entity is operating with capital support from the U.S. Government.

**Open market CLOs**

The Final Rule treats managers of collateralized loan obligations (“CLOs”) as sponsors and generally requires them to satisfy the 5 percent risk retention requirement. The Final Rule also includes a transaction-specific risk retention option for “open-market CLOs” that, subject to certain conditions, permits lead arrangers of senior secured syndicated loans held by the CLO to retain the requisite 5 percent risk, rather than the CLO manager.

**Qualified tender option bonds**

The Final Rule provides that a sponsor with respect to an issuance of tender option bonds (a type of security issued in many securitizations of underlying municipal securities) by a “qualified tender option bond entity” may satisfy its risk retention requirements by holding outside of the issuing entity municipal securities from the same issuance of municipal securities deposited in the qualified tender option bond entity, the face value of which retained municipal securities is equal to 5 percent of the face value of the municipal securities deposited in the qualified tender option bond entity.

A “qualified tender option bond entity” is an issuer of tender option bonds meeting certain requirements, including that the entity be collateralized solely by servicing assets and by municipal securities that have the same municipal issuer or source of payment. Notably, similar to the requirement applicable to an eligible ABCP conduit, the issuing entity must have a legally binding commitment from a regulated liquidity provider to provide a 100 percent guarantee or liquidity coverage with respect to all of the issuing entity’s outstanding tender option bonds. The sponsor must also provide, or cause to be provided, to potential investors certain required disclosures within a reasonable period of time prior to the sale of the bonds. The Final Rule also provides such issuers an option to convert a retained EHRI into an eligible vertical interest upon the occurrence of a “tender option termination event” as defined in Section 4.01(5) of IRS Revenue Procedure 2003-84.

**Transfer of Risk Retention**

**Allocation to an originator**

Under the Final Rule, the sponsor may allocate its risk retention requirement to the originator of the securitized assets under the standard risk retention options, subject to the agreement of the originator and to certain other conditions. “Originator” is defined to include only the original creditor that created the asset through an extension of credit or otherwise, and does not include a subsequent purchaser or transferee of the asset. Any risk retention allocated to an originator reduces the sponsor’s risk retention requirement commensurately.

The originator must acquire the eligible interest from the sponsor at the closing of the securitization transaction and retain such interest in the same manner and proportion (as between horizontal and vertical interests) as the sponsor. Additionally, the ratio of the percentage of the risk position acquired and retained by the originator to
the total percentage of the risk position otherwise required to be retained by the sponsor may not exceed the ratio of the unpaid principal balance of all securitized assets originated by the originator to the unpaid balance of all the securitized assets in the transaction.

Moreover, the originator must acquire and retain at least 20 percent of the aggregate risk retention amount otherwise required to be held by the sponsor, and must comply with the hedging, transfer, and other restrictions (described below) with respect to such interest as if the originator were the sponsor.

**Hedging, transfer and financing prohibitions**

The Final Rule generally prohibits a sponsor from selling or otherwise transferring any retained interest other than to majority-owned or wholly owned affiliates of the sponsor. Moreover, a sponsor and its affiliates may not hedge their required risk retention positions or pledge those positions as collateral for any obligation (including a loan, repurchase agreement, or other financing transaction), unless the obligation is with full recourse to the pledging entity.

Certain hedging activities are not prohibited. Sponsors and their affiliates are permitted to:

- hedge interest rate or foreign exchange risk, or
- hedge based on an index of instruments that includes ABS, subject to certain limitations.

The restrictions on sponsors and their affiliates hedging or transferring retained interests for specified periods after the securitization remain unchanged from the Re-Proposal:

- For RMBS transactions, the restrictions will expire on or after the date that is (1) the later of (a) five years after the closing date or (b) the date on which the total unpaid principal balance of the securitized assets is reduced to 25 percent of the original unpaid principal balance as of the closing date, but (2) in any event no later than seven years after the closing date.

- For all other ABS transactions, the restrictions will expire on or after the date that is the latest of (1) the date on which the total unpaid principal balance of the securitized assets that collateralize the securitization are reduced to 33 percent of the original unpaid principal balance as of the closing date, (2) the date on which the total unpaid principal obligations under the ABS interests issued in the securitization are reduced to 33 percent of the original unpaid principal obligations as of the closing date, or (3) two years after the closing date.

**Exceptions and Exemptions**

The Final Rule exempts certain types of securitizations from risk retention requirements, including “qualified residential mortgage” loans, or “QRMs,” and securitizations backed by auto loans, commercial loans, and commercial real estate loans that meet specified strict underwriting standards.

**Qualified residential mortgages (QRMs)**

Under the Final Rule, a sponsor will be exempt from the risk retention requirement for securitizations consisting solely of QRMs. The Final Rule defines “qualified residential mortgage,” or QRM, to mean a “qualified mortgage” or QM, as defined in Section 129(C) of the Truth In Lending Act and regulations issued thereunder, as amended from time to time, that is not currently 30 or more days past due. The detailed definition of QM is currently set forth in regulations adopted by the Consumer Financial Protection Bureau (“CFPB”) under Section 129(C) for purposes of the CFPB’s “ability-to-repay” rules.
After much debate, the Joint Regulators determined not to adapt the “QM-Plus” concept floated in the Re-
Proposal under which QRM would have been defined as a QM that satisfied additional conditions, including a 
minimum down payment requirement. Thus, under the Final Rule, there is no minimum down payment 
requirement for a QRM.

The Final Rule also added two limited exemptions from the risk retention requirement for certain residential 
mortgage loans in order to conform with the “ability-to-repay” rules of the CFPB. The first is an exemption for 
securitization transactions backed solely by certain community-focused residential mortgage loans (such as loans 
made through state housing agency programs and certain community lender programs) and servicing assets. The 
second is an exemption for qualifying 3-to-4 unit residential mortgage loans and servicing assets. There are also 
provisions permitting sponsors to blend community-focused loans with non-exempt residential mortgages, in 
worse case the minimum risk retention requirement will be 2.5%. or qualifying 3-to-4 unit loans with QRMs, in 
which case the risk retention requirement will be zero.

Qualifying commercial loans, commercial real estate loans, and auto loans

The Final Rule provides an exemption from risk retention requirements for securitizations consisting of 
“qualifying” commercial loans, commercial real estate (“CRE”) loans and automobile loans. Specifically, 
securitizations of such “qualifying” assets are subject to a 0 percent risk retention requirement provided that:

- the assets meet the specific stringent underwriting standards set forth in the Final Rule for each such 
  asset type,

- the securitization transaction is collateralized solely by loans of the same asset class and by servicing 
  assets,

- the securitization transaction does not permit reinvestment periods, and

- the sponsor provides, or causes to be provided, to potential investors, a description of the manner in 
  which the sponsor determined the aggregate risk retention requirement for the securitization 
  transaction.

The underwriting requirements for each of these classes of “qualifying” assets are summarized below.

Qualifying commercial loans

The underwriting standards for qualifying commercial loans include the following, among others:

- prior to the origination of the commercial loan, the originator must have verified and documented the 
  financial condition of the borrower at the end of the borrower’s two most recently completed fiscal 
  years and during the period, if any, since the end of its most recently completed fiscal year,

- the originator must have determined that, based on the previous two years’ actual performance, the 
  borrower had

- a total liabilities ratio (as defined) of 50 percent or less,

- a leverage ratio (as defined) of 3.0 or less, and

- a debt service coverage (DSC) ratio (as defined) of 1.5 or greater, and
• the originator must also have conducted an analysis of the borrower’s ability to service its overall debt obligations during the next two years, based on reasonable projections, and determined that, based on such projections, which include the new debt obligation, following the closing date of the loan, the borrower will have:
  o a total liabilities ratio of 50 percent or less,
  o a leverage ratio of 3.0 or less, and
  o a DSC ratio of 1.5 or greater.

Qualifying commercial real estate loans

The Final Rule defines a qualifying commercial real estate (QCRE) loan as a first lien loan on commercial real estate and improvements, including a ground-leased land loan on improved property, that meets the following underwriting standards, among others:

• a DSC ratio of 1.25 for qualifying multi-family property loans (as defined), 1.5 for qualifying leased CRE loans (as defined), and 1.7 for all other CRE loans,
• a 30-year maximum amortization period for multi-family loans and a 25-year amortization period for other CRE loans,
• a maximum loan-to-value (LTV) of 65 percent and a maximum combined LTV of 70 percent,
• the CRE loan must be fixed rate or swapped to a fixed rate through an interest rate swap or capped with an interest rate cap, and
• the CRE loan may not be interest only or have an interest-only period.

Qualifying automobile loans

The Final Rule defines a “qualifying auto loan” as an automobile loan (but not an automobile lease) that satisfies the following underwriting criteria, among others:

• the originator must have verified specified aspects of the borrower’s credit history,
• the loan must have a debt-to-income (DTI) ratio of less than or equal to 0.36, as verified through payroll stubs and the borrower’s credit report, and
• the borrower must make a down payment of at least (i) 10 percent of the vehicle purchase price plus (ii) all title, tax, and registration fees, dealer fees, and other add-ons.

Blending pools of qualifying, exempt and non-exempt assets

Sponsors of RMBS will generally not be allowed to reduce their risk retention requirements by commingling QRM and non-QRM loans in a single securitization, with a limited exception for commingling QRMs and exempt 3-to-4 unit residential mortgage loans, as described above. However, sponsors of commercial, commercial real estate, or auto loans will be able to reduce their risk retention requirement in proportion to the percentage of “qualifying”
assets included by up to 50 percent (that is, to 2.5 percent) using such “blended pools.” The issuer must also disclose any material differences between the qualifying and non-qualifying assets included in the pool.

Certain foreign-related transactions

The Final Rule includes a limited exemption, or “safe harbor,” excluding from the risk retention requirement certain predominantly foreign securitizations. The foreign securitization safe harbor is available only if all of the following conditions are met:

- registration of the ABS interests is not required under the Securities Act of 1933,
- not more than 10 percent of the value of all classes of ABS interests (including ABS interests retained by the sponsor) are sold to U.S. persons,
- neither the sponsor nor the issuing entity is organized under U.S. law or is a branch located in the United States of a non-U.S. entity, and
- not more than 25 percent of the securitized assets were acquired from an affiliate or branch of the sponsor organized or located in the United States.

General exemptions

The Final Rule includes a number of “general exemptions” from the risk retention requirements (in addition to the exemptions for certain community-focused residential mortgage loans and certain 3-to-4 unit residential mortgage loans described above), including the following:

- certain U.S. Government-backed securitizations of residential, multi-family, or healthcare facility mortgage loans that are insured or guaranteed (in whole or in part) by the United States or an agency of the U.S. Government, or involves the issuance of ABS that are collateralized solely by residential, multi-family, or healthcare facility mortgage loans, which ABS are insured or guaranteed by the United States or an agency of the U.S. Government,
- certain State and municipal securitizations where the ABS are issued or guaranteed by a State, a political subdivision of State, or by certain public instrumentalities of a State,
- certain qualified scholarship funding bonds,
- certain pass-through resecuritizations that are collateralized solely by servicing assets and by ABS for which the requisite credit risk was previously retained or that were exempt from the credit risk retention requirements, provided that the resecuritization is structured so that it involves the issuance of only a single class of ABS interests,
- certain first-pay-class securitizations structured to reallocate prepayment risk and not credit risk,
- securitizations collateralized solely by “seasoned loans” and by servicing assets,
- certain public utility securitizations, and
- securitizations sponsored by the FDIC acting as conservator or receiver for a financial institution.
There is also a reduced risk retention requirement for certain student loan securitizations where the student loans were made under the Federal Family Education Loan Program (FFELP). The risk retention requirement for such securitizations is either 0 percent, 2 percent, or 3 percent, depending on the degree to which such FFELP loan is guaranteed as to default in principal and accrued interest.

Additional exemptions

The Final Rule provides that the Joint Regulators may jointly adopt or issue exemptions, exceptions or adjustments to the risk retention requirements of the Final Rule. Notably, the Final Rule does not give such authority to individual regulatory agencies.

Periodic review of QRM definition and related exemptions

The Joint Regulators must review the QRM definition, and the related exemptions for community-focused and 3-4 unit residential mortgage loans, four years from the effective date of the Final Rule and every five years thereafter, or at any time upon request by one of the Joint Regulators, to determine if the CFPB’s QM definition at such time is still the appropriate definition to use to define QRM and whether such related exemptions are still appropriate.

Market impacts

The Final Rule is expected to have a significant impact on securitization markets generally, although the impact is likely to vary considerably among specific asset classes and transaction structures. The impact of the Final Rule extends to the far reaches of the securitization markets, both because it covers privately placed ABS transactions, such as Rule 144A and Regulation D offerings, in addition to publicly offered ABS transactions, and because it applies to foreign issuers who are not willing or able to limit their offerings in the United States to less than 10 percent of the total transaction even in cases where the offering is predominantly foreign in nature.

Sponsors, and in turn originators, will have substantial incentives to produce “qualifying” assets that are exempt from risk retention requirements when securitized. This will be more easily achieved for some asset classes than others. Due to the significant “loosening” of the requirements for QRMs since the Original Proposal in response to widespread concerns that the definition would inhibit mortgage lending to low- and moderate-income borrowers, it is expected that a relatively large percentage of residential mortgage loans originated in the United States will qualify as QRMs, and can therefore be securitized without a risk retention requirement. In contrast, the requirements for commercial loans, commercial real estate loans and auto loans remain nearly as strict as were initially proposed, and relatively small percentages of loans of these asset types are expected to be “qualifying” assets, such that securitizers of these assets are much more likely than RMBS sponsors to be required to retain risk in accordance with the Final Rule.

This outcome is perhaps most ironic in the case of automobile securitizations and CLOs. While RMBS securitizations were a contributing factor to, and some would claim the principal cause of, the 2008 financial crisis, auto loan securitizations and CLOs performed relatively well through the crisis. Now, under the new risk retention rules, auto loan securitizers and CLO managers are much more likely than residential mortgage loan securitizers to be required to retain “skin in the game” through risk retention.

The Final Rule is one of the last securitization “reforms” to be put in place as the result of the Dodd-Frank Act and other remedial legislation and regulation, as well as accounting rule changes, adopted following the financial crisis. Considering the restrictive requirements that have already been put in place by federal legislation and numerous regulatory agencies, it will be instructive to see whether the addition of risk retention requirements will significantly improve the performance of and confidence in the markets, or whether, instead, it will unnecessarily constrain markets that have largely corrected themselves and performed well since the financial crisis.
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Tougher than Basel

Basel implementation in the United States continues to progress, as shown by the recent release of a proposed rule on the application of the liquidity coverage ratio, or LCR. The proposed LCR is largely consistent with the Basel Committee on Banking Supervision’s LCR standard, but tougher.

The proposed rule would apply to internationally-active banking organisations with $250 billion or more in total consolidated assets, or $10 billion or more in on-balance sheet foreign exposure, as well as designated non-bank systemically important financial institutions that do not have substantial insurance operations. A less stringent version, termed LCR lite, would apply to smaller depository institutions. As under the Basel rule, covered companies would be required to hold high-quality liquid assets (HQLA) of at least 100% of the company’s total net cash outflows over a prospective 30 calendar-day period. However, the types of assets that qualify as HQLA for US banks are more limited than those considered qualifying for European banks. Under the proposed rule, the measure of the rate of cash outflow is also more punitive, as it is based on the bank’s largest net cumulative cash outflow day within a 30-day liquidity stress, as opposed to the more moderate Basel version of this calculation. US banks would have a shorter transition period than that contemplated by Basel. Covered US banks would be required to maintain an LCR of 80% as of January 1 2015, with step-ups until January 1 2017 when the LCR will be fully implemented.

Maybe these more stringent rules should not have come as a surprise, given the pattern that the US banking agencies seem to be setting, with tougher regulatory capital rules and more stringent stress tests. It also seems clear, based on recent speeches from regulators, that more is on the way in 2014. At the very least, the banking agencies seem to be focused on a new long-term debt requirement for large internationally active financial institutions to have minimum amounts of long-term unsecured debt outstanding to absorb losses in an insolvency and facilitate an orderly liquidation. We can also anticipate measures designed to discourage reliance on short-term wholesale funding.

Anna Pinedo

Tel: + 1 212 468 8000

1290 Avenue of the Americas
New York, NY 10104-0050
United States
Web: www.baerkarrer.ch

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