

Definition of HQLAs: U.S. LCR Proposal vs. European Banking Authority Report

The following chart provides a high-level comparison of **(1)** the definition of HQLAs in the U.S. LCR proposal and **(2)** the assets found to be of extremely high liquidity and credit quality (“**extremely HQLAs**”) and of high liquidity and credit quality (“**HQLAs**”) in the European Banking Authority’s recent analysis and report on the uniform definitions of extremely HQLAs and HQLAs.¹

The European Commission (“**EC**”) will consider the European Banking Authority (“**EBA**”) report for purposes of adopting a delegated act to introduce a detailed and harmonized liquidity coverage ratio requirement in the EU pursuant to Article 460 of the EU CRD IV Regulation. Note that the EBA’s empirical analysis is limited to assets denominated in EU currencies.

Haircuts: The EBA report concludes that the minimum haircuts for HQLAs prescribed in the Basel Committee’s LCR framework would be sufficient to guard against likely fluctuations in market prices. Note that the Basel Committee prescribes a 15% haircut for certain corporate debt securities and a 50% haircut for certain other corporate debt securities whereas the U.S. LCR proposal prescribes a 50% haircut for all qualifying corporate debt securities.

Operational Requirements for HQLAs: The EBA report also discusses the following operational requirements for including HQLAs in a bank’s LCR buffer: legal and practical availability; transfer restrictions; control by a liquidity management function; test sales; liquid assets used for hedging or trading strategies and currency consistency.

| Asset Class | EBA HQLA Report (Dec. 20, 2013) | U.S. LCR Proposal (Oct. 24, 2013) |
|------------------------------|--|--|
| Central bank reserves | <ul style="list-style-type: none"> ▪ The EBA analysis does not assess the liquidity of central bank reserves and holdings of notes and coin, which are assumed to be liquid assets by definition. | <p>Level 1 HQLAs:</p> <ul style="list-style-type: none"> ▪ Excess reserves held at Federal Reserve Bank, subject to certain exceptions. ▪ Balances held at foreign central bank that are <u>not</u> subject to restrictions on the banking organization’s ability to use the reserves. |
| Sovereign bonds | <ul style="list-style-type: none"> ▪ Extremely HQLAs: The EBA recommends that <u>all</u> bonds issued or guaranteed by European Economic Area (“EEA”) sovereigns and EEA central banks in the domestic currency be considered extremely HQLAs. <ul style="list-style-type: none"> ○ The EBA explained that: “Although the empirical analysis shows some degree of differentiation in the liquidity features of different sovereign bonds, there are strong supervisory arguments for <u>not discriminating between various Member</u> | <ul style="list-style-type: none"> ▪ Level 1 HQLAs: <ul style="list-style-type: none"> ○ Securities issued or unconditionally guaranteed by the U.S. treasury ○ Securities issued or unconditionally guaranteed by any other U.S. government agency whose obligations are fully and explicitly guaranteed by the full faith and credit of the U.S. government, |

¹ EBA, *Report on appropriate uniform definitions of extremely high quality liquid assets (extremely HQLA) and high quality liquid assets (HQLA) and on operational requirements for liquid assets under Article 509(3) and (5) CRR* (Dec. 20, 2013), available at <http://www.eba.europa.eu/-/eba-publishes-reports-on-liquidity>.

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| | <p><u>State sovereigns</u>. In particular, it should be taken into consideration the eventual and likely damage that an exclusion of some sovereign bonds would create in the European market by triggering incentives to invest in domestic sovereign, thus reinforcing the <u>fragmentation of the Single Market and the sovereigns-banks loop</u>.” (emphasis added)</p> | <p>provided that the security is liquid and readily-marketable.</p> <ul style="list-style-type: none"> ○ Securities issued or guaranteed by a sovereign entity (<i>i.e.</i>, central government or central bank) <u>if</u>, among other requirements, exposures to the sovereign is assigned a 0% risk weight under the U.S. Basel III standardized approach (0% risk weight category generally includes all OECD sovereign debt unless it has defaulted or was restructured in the previous 5 years). <ul style="list-style-type: none"> ▪ Level 2A HQLAs: Securities issued or unconditionally guaranteed by a sovereign entity <u>if</u>, among other requirements, exposures to the sovereign is assigned a 20% risk weight under the U.S. Basel III standardized approach |
| Supranational institution securities | <ul style="list-style-type: none"> ▪ Extremely HQLAs: The EBA recommends that bonds issued or guaranteed by Supranational Institutions (the Bank for International Settlements, the International Monetary Fund, the European Commission, multilateral development banks, the European Financial Stability Facility and the European Stability Mechanism) be considered extremely HQLAs. | <ul style="list-style-type: none"> ▪ Level 1 HQLAs: Securities issued or unconditionally guaranteed by the Bank for International Settlements, the International Monetary Fund, the European Central Bank and European Community or certain specified multilateral development banks. |
| U.S. GSE securities | <ul style="list-style-type: none"> ▪ <u>Not</u> considered in EBA report | <ul style="list-style-type: none"> ▪ Level 2A HQLAs: Securities issued or guaranteed by a U.S. GSE (<i>i.e.</i>, Fannie Mae, Freddie Mac, Federal Home Loan Banks and the Farm Credit System) that is liquid and readily-marketable; investment grade under the OCC’s non-credit ratings based standard; and senior to preferred stock. |
| Corporate debt securities | <ul style="list-style-type: none"> ▪ HQLAs: Corporate bonds rated ECAI 4 or better, minimum issue size EUR 250 million (or the local currency equivalent) and a maximum time to maturity of 10 years. ▪ ECAI rating mapping: The table below shows how external credit ratings mapped to one of the 6 ECAI (External Credit Assessment | <ul style="list-style-type: none"> ▪ Level 2B HQLA: Publicly traded corporate debt security that is liquid and readily-marketable; investment grade under the OCC’s non-credit ratings based standard; issued by an entity whose obligations have a proven record as a reliable source of liquidity in repurchase or |

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|--|--|--|----------------|------------------|---|------------|------------|---|----------|----------|---|--------------|--------------|---|------------|------------|---|----------|----------|---|----------------|----------------|--|
| | <p>Institutions) buckets.</p> <table border="1" data-bbox="344 358 1157 732"> <thead> <tr> <th data-bbox="344 358 401 386">ECAI</th> <th data-bbox="401 358 653 386">Moody's Rating</th> <th data-bbox="653 358 1157 386">S&P/Fitch Rating</th> </tr> </thead> <tbody> <tr> <td data-bbox="344 415 401 443">1</td> <td data-bbox="401 415 653 443">Aaa to Aa3</td> <td data-bbox="653 415 1157 443">AAA to AA-</td> </tr> <tr> <td data-bbox="344 472 401 500">2</td> <td data-bbox="401 472 653 500">A1 to A3</td> <td data-bbox="653 472 1157 500">A+ to A-</td> </tr> <tr> <td data-bbox="344 529 401 557">3</td> <td data-bbox="401 529 653 557">Baa1 to Baa3</td> <td data-bbox="653 529 1157 557">BBB+ to BBB-</td> </tr> <tr> <td data-bbox="344 586 401 613">4</td> <td data-bbox="401 586 653 613">Ba1 to Ba3</td> <td data-bbox="653 586 1157 613">BB+ to BB-</td> </tr> <tr> <td data-bbox="344 643 401 670">5</td> <td data-bbox="401 643 653 670">B1 to B3</td> <td data-bbox="653 643 1157 670">B+ to B-</td> </tr> <tr> <td data-bbox="344 699 401 727">6</td> <td data-bbox="401 699 653 727">Caa1 and below</td> <td data-bbox="653 699 1157 727">CCC+ and below</td> </tr> </tbody> </table> | ECAI | Moody's Rating | S&P/Fitch Rating | 1 | Aaa to Aa3 | AAA to AA- | 2 | A1 to A3 | A+ to A- | 3 | Baa1 to Baa3 | BBB+ to BBB- | 4 | Ba1 to Ba3 | BB+ to BB- | 5 | B1 to B3 | B+ to B- | 6 | Caa1 and below | CCC+ and below | <p>sales markets during stressed market conditions and not issued by a financial entity.</p> |
| ECAI | Moody's Rating | S&P/Fitch Rating | | | | | | | | | | | | | | | | | | | | | |
| 1 | Aaa to Aa3 | AAA to AA- | | | | | | | | | | | | | | | | | | | | | |
| 2 | A1 to A3 | A+ to A- | | | | | | | | | | | | | | | | | | | | | |
| 3 | Baa1 to Baa3 | BBB+ to BBB- | | | | | | | | | | | | | | | | | | | | | |
| 4 | Ba1 to Ba3 | BB+ to BB- | | | | | | | | | | | | | | | | | | | | | |
| 5 | B1 to B3 | B+ to B- | | | | | | | | | | | | | | | | | | | | | |
| 6 | Caa1 and below | CCC+ and below | | | | | | | | | | | | | | | | | | | | | |
| <p>Corporate equity securities</p> | <ul style="list-style-type: none"> ▪ Based on the empirical and principles-based analysis in its report, the EBA found insufficient evidence of market liquidity to propose equities as HQLAs. ▪ <u>However</u>, on the basis of <u>qualitative</u> factors and supervisory judgment, the EBA recommends considering common equity shares as HQLAs in accordance with the eligibility criteria in the Basel Committee's revised LCR framework. <ul style="list-style-type: none"> ○ The EBA observed that: "Equities show high volume based metrics and are found to be very active as collateral in terms of repoability. The international regulatory framework foresees this asset class under the application of high haircuts." | <ul style="list-style-type: none"> ▪ Level 2B HQLA: Publicly traded common equity share that is, among other requirements, liquid and readily-marketable; included in S&P 500 or equivalent index; investment grade under the OCC's non-credit ratings based standard; issued by an entity whose obligations have a proven record as a reliable source of liquidity in repurchase or sales markets during stressed market conditions and not issued by a financial entity. | | | | | | | | | | | | | | | | | | | | | |
| <p>Securities issued by financial institutions (other than covered bonds)</p> | <ul style="list-style-type: none"> ▪ Based on the empirical and principles-based analysis in its report, the EBA found insufficient evidence of market liquidity to propose securities issued by financial institutions (other than securities guaranteed by sovereigns and covered bonds) as HQLAs. | <ul style="list-style-type: none"> ▪ Generally do <u>not</u> qualify as HQLAs | | | | | | | | | | | | | | | | | | | | | |

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| <p>Covered bonds</p> | <ul style="list-style-type: none"> ▪ EBA expressed doubts about including covered bonds as <u>extremely</u> HQLAs <ul style="list-style-type: none"> ○ The EBA observed that: “The analysis shows that some covered bonds display an excellent liquidity based on the available data, which reflects the European covered bond market. Nevertheless, two thirds of the observations come from markets that did not experience a real estate crisis. There are <u>doubts</u> as to whether the findings of the current analysis are sufficient to justify a deviation from the international standards and the inclusion of some covered bonds in the category of <u>extremely</u> high quality liquid assets the characteristic of which is to allow unlimited recourse to such instruments to cover for liquidity requirements.” (emphasis added) ▪ HQLAs: Covered bonds rated ECAI 1 of minimum issue size EUR 250 million (or the local currency equivalent). | <ul style="list-style-type: none"> ▪ Do <u>not</u> qualify as HQLAs |
| <p>RMBS</p> | <ul style="list-style-type: none"> ▪ HQLAs: RMBS rated ECAI 1, minimum issue size EUR 100 million (or the local currency equivalent), a maximum time to maturity of 5 years and subject to the following additional requirements: <ul style="list-style-type: none"> ○ All assets backing an RMBS must be first-lien residential mortgages ○ Only senior tranches can be included ○ The time to maturity of the security shall be calculated using either the first call date of the RMBS or the lowest of either the pricing prepayment assumption as defined in the offering circular or 20% conditional prepayment rate (CPR) ○ For securities which have been issued and outstanding for more than one year and which do not include a call option, the prepayment speed (CPR) to be used when calculating the weighted average life shall be the arithmetic average of: <ul style="list-style-type: none"> ▪ the historical CPR observed since issuance (the lifetime CPR); ▪ the lower of the (i) the pricing CPR as defined in the | <ul style="list-style-type: none"> ▪ Do <u>not</u> qualify as HQLAs |

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| | <p style="text-align: center;">offering circular or (ii) the 20% CPR.</p> <ul style="list-style-type: none"> ▪ ABS not backed by residential mortgages: Based on the empirical and principles-based analysis in its report, the EBA found insufficient evidence of market liquidity to propose ABS not backed by residential mortgages as HQLAs. | |
| Securities issued by state and local governments | <ul style="list-style-type: none"> ▪ HQLAs: Bonds issued by local government institutions in EEA currencies, rated ECAI 2 or above, minimum issue size EUR 250 million (or the local currency equivalent) and a maximum time to maturity of 10 years. | <ul style="list-style-type: none"> ▪ Do <u>not</u> qualify as HQLAs |
| Collective investment undertakings (“CIUs”) | <ul style="list-style-type: none"> ▪ Pursuant to Article 416(6) of the CRD IV Regulation, shares in CIUs, subject to certain requirements and limitations, may be treated as liquid assets provided that a CIU (apart from derivatives to mitigate interest rate or credit or currency risk) only invests in liquid assets eligible for the LCR. | <ul style="list-style-type: none"> ▪ Securities issued by an investment company or non-regulated fund generally do <u>not</u> qualify as HQLAs. |