Federal Financial Analytics, Inc.

FedFin Advisory: Next Steps on the NSFR

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With release of the final Basel net stable funding ratio (NSFR), action begins in earnest to complete liquidity standards with significant market and bottom-line impact not just for the big banks, but also customers and competitors. It is FedFin's longstanding view that it is impossible correctly to forecast regulatory impact without putting each action into the broader regulatory, legislative, and policy context. We have thus taken our in-depth assessment of the NSFR, considered in the context of other actions like capital, margin, and resolution regulation, and reached the following strategic conclusions:

- Basel data suggesting most banks meet the NSFR is misleading. To ensure both compliance and profitability, significant realignment at large banks will ensue, with this taking place most quickly in the U.S. due to the faster pace of U.S. action, higher liquidity regulation, and tough G-SIB leverage requirements.
- Treasury shortages – already an acute concern – will be even more dangerous. Regulators hope collateral transformation will resolve at least some of these shortfalls, but this is at best uncertain, especially given NSFR limits on collateral swaps.
- Wholesale banks face particularly serious strategic challenges because current funding is problematic under the NSFR, as well as in the new liquidity coverage ratio. Alternative funding sources will be difficult to amass under these rules, especially once TLAC kicks in.

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- Core deposits are the NSFR's preferred funding source, but gathering them is problematic until interest rates rise and credit markets normalize. However, profitable deposit deployment will be challenging even then due to leverage capital requirements. This will accelerate the shift of lending into asset-management products originated by banks, finance companies, and private-equity firms that are distributed through investment funds.
- Capital-market operations – most notably reverse repos and clearing – face significant additional costs under the NSFR. In concert with G-SIB leverage requirements, some clearing banks may reduce or even exit derivatives, futures, or other clearing arenas. This will raise end-user costs.
- Mortgage finance faces obstacles because the liquidity rules discount securitization and the NSFR requires higher levels of stable funding for longer-term mortgages than most banks anticipate for prospective books.

This advisory is provided for your information. It is based on an in-depth analysis sent to Federal Financial Analytics clients we would be pleased to provide upon your request by return e-mail. If you have any questions or would like to discuss this with our managing partner, Karen Petrou, please reply by return e-mail or call Tish Thomas at 202-589-0880.

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