# *Financial Services Management*

## Net Stable Funding Ratio

**Cite**

OCC, FRB, FDIC; Notice of Proposed Rulemaking (NPR), Net Stable Funding Ratio: Liquidity Risk Measurement Standards and Disclosure Requirements

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### Impact Assessment

- U.S. regulators calculate a very small NSFR shortfall, but this may be due to current market factors, not the actual impact of the NSFR, especially in concert with other rules.
- The cumulative impact of the NSFR in concert with numerous other U.S. liquidity rules may combine to lengthen funding terms and increase stability at the cost to covered banks of more expensive funding, HQLA shortages, and higher leverage capital requirements. These effects may run counter to the financial-stability goals achieved through the NSFR, especially if large banks cannot replace short-term wholesale funds with cost-effective core deposits.
- The NSFR buffer provides some ability to absorb liquidity stress, but use of it is uncertain and thus banks may nonetheless hold large NSFR buffers not only to ensure compliance with this rule, but also to meet numerous other liquidity requirements.
- Limits on including excess liquidity in consolidated subsidiaries under both the LCR and NSFR will encourage use of branches for international operations to the extent possible under applicable law and to the extent compatible with resolution-plan approval. Temporary exemption from the liquidity rules for certain U.S. operations of foreign banks will also encourage branch operations in this country.
- BHC expectations of intra-group transfers from insured depositories would be subject to new restrictions, requiring additional liquidity at non-IDI

subsidiaries (including broker-dealers, asset management). BHCs may restructure to house liquidity-dependent activities in IDIs where possible, perhaps increasing FDIC-resolution challenges.

- RSFs set for certain asset classes (e.g., matched-book and reverse repos, corporate bonds) are higher than many banks think appropriate for liquidity-risk management purposes, creating costs that may reduce individual bank positions in such asset classes with an overall adverse impact on market liquidity.
- Banks will have little time to ensure NSFR compliance as the rule is unlikely to be finalized until close to year-end, if not later, and it would be effective on January 1, 2018. Significant planning and operational changes may thus need to begin without the certainty of a final regulation. LCR changes made by this rule would take effect even faster, adding to this challenge.

## Overview

The U.S. has finally advanced its version of Basel's net stable funding ratio (NSFR)[1] with a proposed rule that, while generally tracking the global framework, is like the U.S. liquidity coverage ratio (LCR)[2] more stringent in several respects. Although the banking agencies have calculated a minimal shortfall they believe covered banks will easily make up by the rule's effective date, the NSFR nonetheless will combine with numerous other capital and liquidity rules to redefine the way in which large banks engage in certain businesses (e.g., repos). As a result, the cumulative impact of the NSFR and other liquidity rules will likely make covered banks more resilient to idiosyncratic funding stress, but less active in key markets on which both financial-services firms and governments depend especially as rates rise, adversely affecting overall market liquidity. Like the global rule, the U.S. one requires banks over a one-year period to have a 100 percent ratio of available stable funds (ASF) to required stable funds (RSF), although this ratio may decline somewhat under stress if various requirements are also met. ASF are defined to favor core deposits, certain operational deposits, and high-quality liquid asset (HQLA) holdings, consuming balance-sheet capacity given the capital cost of these assets and creating other challenges despite the benefit to longer-term funding resilience. RSFs provide very favorable treatment for cash, excess reserves, and most HQLAs, but mandate ASF backstops for repos and certain other assets in ways that are sometimes at odds with ASF calculations and in several cases assume liquidity risk not generally accepted by industry experience. These NSFR requirements apply to all BHCs above \$50 billion, but those below \$250 billion come under a modified, less stringent ratio despite coverage under the overall operational and disclosure standards.

1 See **LIQUIDITY18**, *Financial Services Management*, November 18, 2014.

2 See **LIQUIDITY17**, *Financial Services Management*, October 1, 2014.

## Impact

In addition to the LCR and now the NSFR, large U.S. banks and BHCs are also covered by inter-agency liquidity-risk management standards,[3] systemic liquidity standards designed to ensure effective management, governance and stress testing,[4] a capital surcharge applied to GSIBs that includes a funding-risk component,[5] the total loss absorbing capacity (TLAC) standards,[6] and the comprehensive liquidity adequacy review (LCAR), a liquidity-stress test for which details have not been generally made public. The agencies argue in this NPR that the NSFR builds on all of these requirements and thus is compatible with them, but numerous interactions and potential challenges arise.

Key to the NSFR – and indeed to all of these liquidity requirements – is the assumption that banks can seamlessly transform risky funding sources (generally characterized as short-term and wholesale ones such as overnight instruments and MMFs) into "sticky" deposits unlikely to flee at the first sign of trouble. The liquidity rules are also girded by expectations that banks can hold the necessary amount of HQLAs necessary to ensure stability, but each of these assumptions is not clearly borne out in the market as the rules are finalized nor has any been tested as rates normalize for current ultra-low conditions. Quantitative assessments that suggest U.S. banks will have little difficulty achieving the NSFR may well mask structural effects with significant adverse effect not only for covered banks, but also broader markets. Some if not all of these adverse effects might be offset by overall improvements in financial-market resilience, but they in brief include:

- Collateral shortages: Global regulators have already highlighted the impact of the new liquidity rules[7] due to potential shortages of the HQLAs needed not only to meet the LCR and NSFR, but also to handle new margin requirements.[8] Some of these shortages should reverse as economic growth rebounds, but many will persist due to the new rules and lead not only to collateral transformation and its potential systemic risk, but also to a greater role for non-bank intermediaries exempt from the liquidity rules despite potential liquidity-risk problems of systemic scope.

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3 See **LIQUIDITY6**, *Financial Services Management*, March 24, 2010.
4 See **LIQUIDITY15**, *Financial Services Management*, February 27, 2014.
5 See **GSIB7**, *Financial Services Management*, July 23, 2015.
6 See **TLAC3**, *Financial Services Management*, November 10, 2015.
7 See **SYSTEMIC67**, *Financial Services Management*, May 31, 2013.
8 See **DERIVATIVES28**, *Financial Services Management*, November 3, 2015.

- Capital Cost: HQLAs come under the global leverage ratio[9] and the tougher U.S. SLR,[10] as well as any leverage surcharge Basel may come to impose on GSIBs. As a result, these low-risk assets (including cash) are capital-intensive. Mark-to-market changes in HQLAs also increase capital volatility, leading many banks to hold large HQLA volumes as held-to-maturity (HTM) obligations. The combined effect of these rules may undermine resilience under stress if HTM assets must be sold as well as reduce credit capacity.
- Central-Bank Liquidity: Inter-bank funding commitments are costly under the LCR and NSFR, creating incentives for liquid banks to constrain these, especially under stress and thus exacerbating risk to less-liquid banks that may be forced to turn far more quickly to ordinary or even emergency central-bank liquidity facilities and then to have difficulty obtaining funding due to the scarcity or cost of HQLA collateral.
- Ring-Fencing: The most recent resolution-plan round[11] took a very dim view of cross-border branch operations for the largest U.S. banks on grounds that funding and capital could be trapped abroad by host-country regulators. Consolidated subsidiaries would help to solve for this, but the LCR and now the NSFR proposal would add an express funding constraint on excess liquidity in these entities that encourages use of branches (where excess funding is presumed freely to transfer to the parent). The confluence of these competing standards may be to lead U.S. banks to form more consolidated subsidiaries and fund them only to the minimum extent required to pass the U.S. NSFR, perhaps leaving the consolidated BHC short of ASF and creating a *de facto* additional NSFR requirement. Foreign banks would not now be subject to the LCR or NSFR except if they are of a size or structure expressly subject to the rules, promoting continued branch operations unless or until the FRB finalizes planned rules to ensure sufficient liquidity in the U.S. under U.S. rules for branched operations.
- Intra-Group Transfers: BHCs can only assume intra-group liquidity if funds can move without problematic restriction from insured depository institutions (IDIs) to other entities in conformity with inter-affiliate transaction and similar state and federal restrictions. Resulting limitations on use of IDI funds may encourage BHCs to house as many other activities that rely on IDI funding as possible within the IDI charter instead of a separate BHC operation. This could increase overall IDI risk if these additional operations pose credit, operational, or similar challenges.

9 See **LEVERAGE9**, *Financial Services Management*, April 13, 2016.
10 See **LEVERAGE6**, *Financial Services Management*, April 14, 2014.
11 See Client Report **LIVINGWILL12**, April 20, 2016.

## What's Next

The FDIC approved the NPR on April 26 and the FRB did the same and added the modified treatment for smaller BHCs at its meeting on May 3.[12] The OCC has also approved the NPR, which is out for comment until August 5. Banks and other covered entities would need to comply by January 1, 2018, a shorter implementation period for U.S. companies due to the delay in the U.S. issuing this proposal following Basel's final action on it in 2014. As discussed, the NPR also changes several aspects of the LCR, and these would take effect at the end of the first quarter after this final rule is issued.

## Analysis

The analysis below focuses on key strategic issues rather than on the details of this proposal.

### I. Scope

### A. General NSFR

The NSFR would apply to the same large banking organizations subject to the LCR:

- BHCs, SLHCs, and depository institutions with assets over $250 billion or $10 billion or more in on-balance sheet foreign exposure; and
- depository institutions with $10 billion or more in total assets if they are consolidated subsidiaries of these companies.

Exempted institutions include:

- federal branches and agencies of foreign banks should any come over the $250 billion limit;
- grandfathered Unitary Thrift Holding Companies;
- designated non-bank SIFIs, where the FRB will decide when and how to apply the NSFR. Any decision to do so would be subject to notice and comment either to the affected institution or the group of affected SIFIs;
- regulated holding companies above insurance and commercial thresholds;
- the U.S. operations of foreign banks and any intermediate holding companies (IHCs) that do not otherwise meet the criteria noted above; or
- any bridge holding companies formed by the FDIC in a resolution.

12 See Client Report **QFC3**, May 3, 2016.

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### B. Modified NSFR

Any BHC or SLHC that meets the NSFR-eligibility criteria with assets between $50 billion and $250 billion would come under the FRB's modified approach. Its NSFR would be 70 percent, not the 100 percent ratio required of larger firms, but the rest of the NSFR and related disclosures would apply.

### C. Reservation of Authority

All of the agencies reserve their authority to apply the NSFR as deemed necessary regardless of these eligibility requirements. The agencies also reserve their authority to impose a higher NSFR or otherwise vary these standards for individual covered institutions.

### D. Definitions

Where definitions are changed from those in the LCR rule, they would be applied to both the LCR and NSFR after this NPR is finalized. The funding provisions of the GSIB surcharge would similarly change. Those particularly important to NSFR, LCR, and surcharge impact include:

- revision to the definition of "committed" facilities to conform this to the provisions in the risk-based capital rules[13] that define "unconditionally-cancellable" commitments as those eligible for a zero credit-conversion factor. Based on this, most home-equity and credit-card lines would not be considered committed credit funding;
- expansion of the definition of "operational deposit" to include not only those placed with the bank, but also those that a bank places with others in connection with operational services (e.g., payroll). Only deposits would constitute operational deposits, not other forms of funding or lending to wholesale customers or counterparties, with eligible deposits now also required to have short-term maturities (at least less than six months and generally within thirty days); and
- treatment as secured funding or lending only if the security is a lien on securities (other than those owned or issued by the bank) or loans, not on other assets, tightening the definition on grounds that only this type of security is sufficiently liquid under stress. Collateralized transactions with retail counterparties must still come under the retail rules.

Several new definitions are also added specific to the NSFR including one for NSFR regulatory-capital elements which redefines capital to reflect instruments (e.g., goodwill) that require funding under the NSFR. Comment is solicited on whether this measure should be further tightened (e.g., to reflect adjustments to the fair value of a liability due to changes in the bank's own credit risk).

### E. Consolidation

The NSFR is generally to be calculated on a consolidated basis, but BHCs would need to take into account any restrictions on their ability to access liquidity in

13 See **CAPITAL200**, *Financial Services Management*, July 15, 2013.

consolidated subsidiaries. Excess amounts of liquidity in consolidated subsidiaries could count towards the parent only if assets can be readily transferred to the parent company taking into account statutory, regulatory, contractual, or supervisory restrictions. Applicable restrictions include the inter-affiliate transaction restraints in U.S. law[14], restrictions imposed by state insurance regulators (presumably including those pending now to limit the FRB from requiring insurance subsidiaries to support affiliated banks[15]), and cross-border restrictions. Numerous documentation and operational requirements apply to any situation in which the bank or BHC expects to use excess funding in a consolidated subsidiary.

### F. Shortfalls

The NSFR proposal tracks the LCR with regard to shortfalls. Covered banking organizations may fall below the NSFR in rare circumstances without necessarily being sanctions by their regulators. Banks would need however to notify their regulator within ten days if the NSFR indeed falls short or might do so, with the appropriate agency then having options ranging from informal reply to civil money penalty. Any shortfall would need to be addressed promptly by the bank with a remediation plan within ten days if it identifies a shortfall, one is seen on a disclosure, or the regulator informs it of the need to begin remediation. Once a plan is in place, banks would need to report monthly on their progress under it and are subject to sanction if regulatory expectations go unmet.

## II. NSFR Components

### A. Timing

Although the NSFR is reported at quarter-end, banks are to monitor it and adjust their ratio during the quarter as ASF or RSF factors change.

### B. Factors

The ASF and RSF would generally be determined by their balance-sheet GAAP carrying value. Various rules of construction apply to many NSFR-calculation and reporting requirements (e.g., with regard to netting, treatment of assets received in securities lending). ASFs and RSFs also vary based on maturity, as detailed in the NPR and in a manner consistent with the conservative approach taken in the LCR other than with regard to NSFR-recognized capital elements.

#### *1. ASF*

The ASF amount would equal the sum of the carrying values of the NSFR regulatory-capital elements and NSFR liabilities, multiplied by ASF factors assigned based on the stability of each category of NSFR liability or NSFR regulatory capital element over the NSFR's one-year time horizon. ASF factors (i.e., weightings) range from zero to 100% and are based on:

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14 See Client Reports in the **REGW** series.

15 See **INSURANCE48**, *Financial Services Management*, June 12, 2015.

- tenor (i.e., less than six months, between six months, and one year, and over one year, with weightings favoring the longest-term funding to reduce rollover and related risks). Tenors for open-end funding (e.g., retail deposits) vary based on expectations of likely redemption;
- type based on expectations that some funding (e.g., non-brokered retail and operational deposits) is more stable; and
- counterparty (e.g., a depositor with other customer relationships) or financial company seen to be a less stable funding provider. Wholesale funding providers other than financial entities are deemed to have mid-range stability, with counterparty assessments also affected by funding tenor and type. The best ASF factor applies to NSFR regulatory-capital instruments and most long-term funding liabilities (presumably including most, if not all, TLAC-eligible long-term debt). Brokered deposits are broken into categories and given varying ASFs based on stability expectations. In contrast to the LCR, ASFs for secured-funding transactions and unsecured wholesale funding without regard to whether or not there is collateral and what type of collateral may be provided, based on the agencies' view that long-term funding stability is less influenced by collateral liquidity under the stress scenarios underlying the LCR.

Funding from central banks is considered the equivalent of funding from financial-sector entities (i.e., unstable) to discourage over-reliance on central banks. Although operational deposits are still favored over non-operational deposits, the NSFR treatment is less lenient on grounds that these funds could move during the one-year time horizon (difficult to accomplish within the thirty-day one covered by the LCR).

### *2. Overall RSF*

RSF amounts would be based on the liquidity characteristics of assets, derivative exposures, and commitments. They would equal the sum of:

- most asset carrying values and undrawn amounts of commitments, multiplied by the RSF factor; and
- derivative RSF amounts, also multiplied by the RSF factor.

Like the ASF, RSF factors are scaled from zero to one hundred, with a zero weighting indicating no need for ASF. RSFs are based on:

- credit quality, with the least required funding needed for the highest-quality assets (e.g., cash, certain Reserve Bank balances, and USGs). GSE obligations receive favorable treatment, albeit less so than most direct sovereign obligations;
- tenor, with the RSF favoring shorter-term assets. Undrawn commitments get varying treatment based not only on terms, but also on factors such as the customer's risk and the resulting likelihood of a draw;
- type of counterparty, with RSFs penalizing assets banks might be compelled to roll over to maintain customer relationships or franchise value such as loans to non-financial wholesale borrowers;

- market characteristics, with these factors favoring assets traded in transparent, diversified, large, and standardized markets; and
- encumbrance. Assets held in segregated accounts would be assigned the applicable RSF to the asset not subject to such segregation because monetization of the asset is principally a customer, not bank, decision. Cash placed on deposit with another depository pursuant to a segregation agreement is a short-term loan to a financial-sector entity under the fifteen percent RSF. Rehypothecated assets not on the bank's balance sheet are considered a possible liquidity risk and thus come under varying RSFs depending on the nature of the transaction.

The FRB – but not the other agencies – has recently liberalized the treatment of certain municipal obligations, allowing qualified obligations to be considered as Level 2B HQLAs.[16] The RSF factor for Level 2B municipal bonds would thus be the same fifty percent one granted to other Level 2B assets for banks under the FRB and for BHCs even though the treatment of all other general-obligation bonds is more stringent.

### *3. Derivatives RSFs*

Reflecting the complexity of derivatives instruments, derivatives liabilities are not ASF and their RSFs are complex. The NSFR covers mortgage-related derivatives even though they are covered differently in the LCR. In general, RSFs are calculated by:

- current value;
- initial margin or assets contributed to a CCP default fund; and
- potential future changes to value determined by a standardized approach in the NPR. Potential future changes in margin requirements are also covered by standardized RSFs designed to protect the bank from having to find funding to support them.

### *4. Margin Requirements*

RSFs would be assigned to variation margins provided by the bank based on whether it reduces derivatives liabilities value or is excess variation margin, which would come under the RSF applicable to the instrument(s) comprising the margin position. All variation margins held on the bank's balance sheet would come under the applicable RSF, an approach that would strongly favor cash variation margins. Obligations to return initial or variation margin back to the bank would have a zero ASF.

[16] See **LIQUIDITY25**, *Financial Services Management*, April 6, 2016.

### *5. Customer-Cleared Transactions*

Transactions submitted to CCPs when a bank is acting as an agent for a customer would not count towards the ASF or RSF even if the bank has backed them with a guarantee unless the guarantee meets certain conditions. When the bank acts as principal in CCP transactions, then various RSFs and ASFs apply.

### *6. CCP Default Funds*

These contributions would receive an 85 percent RSF. Initial margins provided by the bank as principal generally receive the RSF applicable to the underlying asset.

## III. Disclosures

These requirements would apply to holding companies subject to the NSFR, but not to IDIs absent a separate rulemaking under notice and comment the agencies anticipate at a future date. Using a standardized format, the disclosures would cover the elements in the ASF and RSF as well as various qualitative factors. The qualitative disclosures could be combined with those made for the LCR under a pending proposal on LCR disclosures.[17] These disclosures would be quarterly and subject to an array of requirements stipulated in the NPR.

## IV. Request for Comment

Views are particularly solicited on:

- the single-quarter transition period required for LCR changes and for large banks that come under the NSFR (those under the modified rules get a one-year transition). Comment is also sought on the overall deadline for NSFR compliance;
- whether retail-deposit contractual features should affect ASFs;
- whether the treatment of undrawn funding commitments should be revised, perhaps by permitting netting with certain HQLAs;
- competitiveness considerations due to differences between the Basel and U.S. RSFs;
- the RSFs assigned to off-balance sheet assets, with comment particularly solicited on an alternative approach laid out in the NPR;
- the measurement of derivatives' future exposure and possible alternatives to it;
- an alternative laid out to handle potential changes in margin requirements;
- whether additional changes should be made to the modified NSFR, especially with regard to the consolidated requirements; and
- if smaller BHCs will undergo undue operational burden.

[17] See **LIQUIDITY23**, *Financial Services Management*, December 11, 2015.