Financial Services Management

Net Stable Funding Ratio (NSFR)

Cite
FRB, OCC, FDIC; Final Rule, Net Stable Funding Ratio:
Liquidity Risk Measurement Standards and Disclosure Requirements

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Websites:
https://www.fdic.gov/news/board/2020/2020-10-20-notice-dis-b-fr.pdf

Impact Assessment

- The NSFR adds a requirement specifically focused on balance-sheet liquidity to many other direct and indirect U.S. liquidity-resilience requirements. It may enhance stability at potential cost to unintended interactions among all these rules along with the capital framework.
- Covered banks generally meet the new NSFR, but this may be due at least in part to unusual deposit inflows during the current crisis. Over time, funding costs are likely to rise for all covered companies that do not change their asset mix in response to new requirements.
- The final NSFR will not add further impediments to large bank dealer capacity in the repo and reverse repo market, but banks – not the Fed – may also bear more risk as a result.
- Banks affiliated with broker-dealers that rely on internal sweep accounts for both funding and customer value face significantly-eased NSFR costs.
- Custody banks will bear greater costs related to operational deposits.
- U.S. NSFR standards are less stringent than Basel requirements but global regulators are likely to accept them, maintaining the overall Basel decision-making construct.

Overview

After expectations that the U.S. might well not adhere to the Basel Committee's NSFR standards,[1] the banking agencies have finalized their 2016 proposal,[2] albeit in significantly revised form. However, like the NPR, the final rule is not designed as a stress liquidity metric or cash-flow buffer; instead, it is intended to ensure balance-sheet resilience based on likely liability and asset flows over the course of one year at any point in time over that year. The most important changes revise the requirements applicable to Treasury obligations and secured exposures collateralized by them, thus affording Treasury securities and other level 1 high-quality liquid assets (HQLAs) under the liquidity coverage ratio (LCR)[3] the same, very favorable treatment applied to cash. The final rule also significantly scales back the number of banking organizations required to adhere to the NSFR in light of the new tailoring rules.[4] Many covered banking organizations already comply with the NSFR, leading the agencies to discount widespread or negative impact. However, some of the benefits expected from changes to the final rule (i.e., increased dealer-bank capacity) may not materialize unless banks remain as liquid and choose to use additional regulatory flexibility as regulators think best under stress. Fewer large U.S. banking organizations are covered by the NSFR, which now also provides more favorable treatment for derivatives exposures and affiliate-sweep accounts. However, the final rule does not significantly reduce the proposal's cost to custody banks.

Impact

Given the length of time it took U.S. regulators to consider their NSFR proposal, many observers and even a good number of regulators expected that the U.S. would agree with commenters that the LCR rule sufficed in concert with FRB enhanced liquidity-risk standards for the largest banking organizations[5] and total loss-absorbing capacity (TLAC) rules.[6] However, global regulators have pressured the U.S. to conform its standards to the Basel NSFR framework to prevent overall dissolution of agreement on this requirement and, perhaps, even on the Basel process more generally. Because the U.S. is committed to the Basel process, it decided to finalize the NSFR even though its final rules differ in several key respects from Basel's baselines.

This might lead to criticism and renewed disputes, but the EU's version of the NSFR is also materially different than the Basel standard. As a result, the U.S. rule should stand without material challenge in the global arena even as changes to the

[1] See **LIQUIDITY18**, *Financial Services Management,* November 18, 2014.
[2] See **LIQUIDITY26**, *Financial Services Management*, May 5, 2016.
[3] See **LIQUIDITY17**, *Financial Services Management,* October 1, 2014.
[4] See **SIFI34**, *Financial Services Management*, October 23, 2019.
[5] See **LIQUIDITY23**, *Financial Services Management,* December 11, 2015.
[6] See **TLAC6**, *Financial Services Management*, December 21, 2016.

proposal allay at least some of the significant concerns that blocked action on the initial proposal.

The ratio of available stable funding (ASF) to required stable funding (RSF) should be 1.0, but the agencies note that a period of "extreme stress" might lead to a temporary drop below this level. Prompt notice in such cases is also mandated, with the rule also noting broad supervisory discretion to do anything ranging from nothing to punitive action. Although the final rule includes a statement that the agencies will "generally support" a bank if it has an NSFR shortfall during a crisis period when this is necessary to ensure lending, most banks will strive to retain a buffer above minimum NSFR requirements, exacerbating potential adverse effects but increasing resilience.

As discussed below, the final rule has significant revisions that led FRB Governor Brainard and FDIC Director Gruenberg to oppose the final standard. However, despite these changes, the final rule will force at least some covered banks to raise longer-term funds to ensure NSFR compliance and the sector as a whole will need to ensure ongoing alignment of longer-term funding and longer-term assets.

The agencies believe that this will make covered banking organizations more resilient, and it may well do so. However, if banks increase long-term debt, they will be more liquid as intended by the NSFR but also more exposed to interest-rate risk. While interest-rate risk may be hedged (albeit at increased cost), longer-term debt may nonetheless put added pressure on net interest margins and thus on bank profitability. If this becomes too strained, risks for certain companies or even the system will also increase. Banks could instead reduce holdings of longer-term assets, but doing so may add credit risk if shorter-term assets are higher risk ones in order to maintain profitability. Longer-term assets also have significant macroeconomic impact since they finance housing and the economic infrastructure. A reduced bank role could have adverse structural implications and/or lead to a still larger role for nonbank financial intermediaries (NBFIs).

As noted, the NSFR is designed to ensure balance-sheet resilience, differentiating it in the agencies' view from the LCR, which focuses on short-term cash flow. Many comments on the proposed NSFR sought alignment of numerous NSFR and LCR categories and definitions, but the agencies rejected many of these because of the NSFR's different objective. Among the most significant implications of the NSFR's focus thus is the lack of recognition of security or collateral in liquidity-risk requirements – i.e., just because an exposure is secured or collateralized does not give it more favorable treatment. The agencies believe that funding risk is often independent of counterparty collateral under stress. As a result, major sources of secured funding – e.g., Home Loan Bank advances – are treated conservatively regardless of the collateral posted to obtain them.

Here, the agencies also note that FHLBanks themselves engage in maturity transformation and might not be able to renew funding commitments under stress even if banks then have the requisite collateral. This is consistent with the regulators' overall cautious approach to the Home Loan Bank system, which some fear has taken on considerable rollover risk.[7]

Perhaps the most important change in the final rule is the treatment of exposures related to the repo and reverse-repo market. The agencies did not change the ASF factor for the funding instruments associated with these transactions, giving them the least favorable possible factor. Instead, they significantly changed the RSF factor associated with these exposures, meaning that no express stable funding is needed to meet the requirement offsetting the stringent ASF factor. The agencies also plan to monitor this market closely to determine both if the ASF factor is too conservative or the RSF factor is too risky. But, with this change, banks via their primary-dealer operations may well be better able to support key financial-infrastructure markets under stress, reducing the need for the Fed to step in as it did in the fall of 2019 for the repo market and again in 2020 during the March COVID crisis. It is also worth noting that U.S. and global regulators are now conducting an overall review of Treasury-market structure in the wake of these crises, anticipating greater stability due to the final NSFR standard but nonetheless fearing continuing stress due in part to very large Treasury issuances resulting from the federal deficit.

Another significant change from the global standards deals with variation margins. Differing also from the U.S. proposal, the final rule does not require that variation margin fully offset an exposure to be recognized for netting purposes to gain recognition in NSFR calculations. The agencies decided this is needed since operational reasons or short-term market disputes may affect variation margin and that failing to permit this flexibility would lead to undue funding volatility. However, it could also lead to greater risk, especially under stress.

Another significant change provides far more generous treatment for affiliate sweep deposits not fully covered by deposit insurance. The agencies decided to do so on grounds that, in this specific arrangement, affiliate funding channels are reliable, but FDIC Director Gruenberg complained that this might not be the case because, under stress, customers may terminate relationships that create sweep-funding flow.

As noted, the final NSFR covers fewer banking organizations than proposed due to the implementation of tailoring standards over intervening years. The NSFR follows the tailoring rule with respect to intermediate holding companies (IHCs) for foreign banking organizations (FBOs), rejecting comments arguing that parent-company liquidity rules sufficed to protect the downstream IHC. The final rule also tracks the tailoring rule by not applying the ratio to FBO branches and agencies, with the final rule instead reiterating that this issue remains under review.

The rule differs from the NPR also by requiring NSFR public disclosures only semi-annually, not quarterly. The agencies say that more frequent disclosures might have "unintended" results but do not specify what these might have been beyond implying that more frequent disclosures could have inhibited intra-quarterly flexibility to address stress situations. The Fed also states that it will monitor holding-company

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7 See **GSE-022620**, *GSE Activity Report*, February 26, 2020.

reporting to identify NSFR shortfalls prior to public reports to ensure liquidity resilience.

What's Next

All of the banking agencies approved this rule on October 20, with FRB Gov. Brainard and FDIC Director Gruenberg dissenting. The rule is effective on July 1, 2021. A proposal will follow to set its liquidity reporting standards for complex banks.

In response to the pandemic and the resulting Money Market Liquidity Fund and the PPP Liquidity Fund,[8] the banking agencies neutralized the LCR for bank participation.[9] The NSFR final rule does the same.

Analysis

This analysis addresses aspects of the final rule with strategic and policy impact. Clients are referred to the final rule for compliance and technical matters.

A. Framework

The final NSFR applies as follows:

- a full NSFR for Category I and II banks as well as Category III banks with more than $75 billion in short-term wholesale funding as defined in the tailoring rule;
- under an 85 percent version of the full NSFR, to Category III organizations with less than $75 billion in weighted wholesale short-term funding;
- with a 70 percent standard, to Category IV organizations with $50 billion or more in weighted short-term funding;
- to depository institution subsidiaries of these holding companies with more than $10 billion in assets based on NSFR applicability to the parent. However, if the parent is a Category IV organization subject to the NSFR, no subsidiary depositories are covered; and
- to IHCs based on their risk profile according to the tailoring rule, not to the FBO's combined U.S. operations.

The rule also applies on a consolidated basis, including restrictions on funds at consolidated subsidiaries. Excess ASF amounts at these subsidiaries may be counted if they can be transferred to the top-tier parent, with the parent required to adopt procedures to track and control excess-ASF reliance.

8 See Client Report **COVID10**, April 9, 2020.

9 See **LIQUIDITY31**, *Financial Services Management*, May 7, 2020.

B. Definitions

In general, the final NSFR definitions track those in the LCR, providing clarification on key terms such as "liquid and readily marketable" applicable to both standards. Definitions of note changed in the LCR and codified in the NSFR include:

- operational deposit, with the definition limiting preferential treatment for these funds only when a fund depositor is regulated and excludes accounts with incentives related to excess funds;
- sweep accounts, which include both brokered and non-brokered deposits in conformity with applicable FDIC definitions as finalized in 2019[10] and as the FDIC may further define them;[11] and
- secured funding or lending transactions, which are those that are backed by HQLA (not other assets such as gold), which are funding transactions that are not securities or are with a wholesale customer or counterparty, and are secured under law by liens on third-party short-term debt or commercial paper from a covered company. A similar standard applies to secured lending.

C. Scope

The rule continues to cover all on-balance sheet exposures, including the securitization commenters sought to have excluded. The final rule also retains the proposed treatment for asset exchanges in the course of securities financing transactions to reflect the balance-sheet focus of the NSFR.

The earliest possible maturity date applies to NSFR liabilities and the latest possible date for an asset. Conservative assumptions are required for options. Principal-payment dates are to be treated as separate transactions. All NSFR regulatory capital elements are assumed to have a one-year maturity.

D. Available Stable Funding (ASF) Requirements

ASF requirements reflect the agencies judgment about stability over the course of a year, now taking policy considerations also into account. Zero is the lowest stability and 100 is the highest – i.e., the funding is expected to be completely stable, with these factors determined by maturity buckets and funding type. The final rule retains specific maturity buckets even though these may create cliff effects to enhance simplicity and conformity to the Basel standard. With the significant exception of sweep accounts, the final rule treats funding from affiliates (including insured depositories) the same as non-affiliated financial institutions due to agency concerns about correlation and other risks. Clients are referred to the rule for specific ASFs, with key strategic points as follows:

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10 See **DEPOSITINSURANCE108**, *Financial Services Management*, January 2, 2019.

11 See **DEPOSITINSURANCE109**, *Financial Services Management*, January 6, 2020.

- There is a 100 percent ASF factor for regulatory-capital elements and liabilities with maturities over one year.
- A 95 percent ASF factor applies to stable retail deposits, i.e., those covered by deposit insurance, in a transactional account or placed by a depositor with another established relationship with the bank. Unlike the NPR, this ASF factor also applies to retail affiliate sweep accounts if the deposit is fully insured and the bank satisfies its regulator that the deposit is highly unlikely to be withdrawn under stress. A proposal to make a similar change on sweep accounts to the LCR may be proposed for public comment.
- A ninety percent ASF Factor covers certain non-brokered retail deposits that are not fully insured by the FDIC or are insured by other entities. This factor also covers reciprocal brokered deposits under certain conditions and some other brokered deposits due to their liquidity characteristics. The agencies note that these deposits may well increase a bank's risk of failure, but the NSFR is not designed to address this. Affiliate sweep accounts not eligible for the 95 percent factor also fall into this category.
- Most forms of secured or unsecured wholesale funding from counter-parties that are not central banks or financial-sector entities with residual maturity of less than a year and most forms of non-deposit retail funding receive a fifty percent ASF factor. All wholesale operational deposits regardless of maturity all fall into this category. Public-sector funding and Home Loan Bank advances also fall into this category unless they have longer maturities. In addition, fifty percent factors apply to securities issued by the banking organization, secured funding transactions, and unsecured wholesale funding maturing in more than six months but less than one year from a financial-sector entity. The same is true for funding from a central bank.
- Operational deposits also receive a fifty percent ASF factor, increasing their cost to the custody banks that hold large balances of these funds. Certain brokered deposits and non-affiliate sweeps also receive the fifty percent ASF factor, as does funding from a retail customer that is not a deposit or security (i.e., to retail brokerage payables).
- A zero ASF factor goes to trade-based payables, certain short-term retail brokered deposits, short-term securities issued by the company, short-term funding from financial entities or central banks, and other NSFR liabilities maturing in less than six months. This includes central-bank funding such as the discount window to encourage reliance on market funding. Any other liabilities and open-end or contingent ones (e.g., unused FHLB lines) also receive a zero factor.

E. Required Stable Funding (RSF) Factor

1. Calculation

The RSF is the sum of carrying value of assets other than those addressed in the derivatives calculation, undrawn, committed credit and liquidity facilities, multiplied by the RSF factor (see below). The RSF amount related to derivatives is then added. Various maturity, tenor, counter-party, encumbrance, credit quality, and market characteristics also set the RSF factor.

2. Factors

RSF factors are summarized below:

- A zero RSF factor applies to cash, own central-bank reserves, certain other highly-liquid assets without credit risk, and – a change from the NPR – to Level 1 HQLAs and certain short-term, secured lending transactions with financial companies backed by rehypothecatable level 1 liquid assets. The latter are said to have only "minimal" funding risk and are critical to key short-term funding markets. As noted, this change is controversial and differentiates the U.S. rules from Basel's.
- A five percent factor applies to encumbered Level 1 HQLAs as well as to the undrawn amounts of committed credit and liquidity facilities provided to customers and counter-parties that may be drawn during the year.
- Unencumbered Level 2 HQLAs receive a fifteen percent RSF factor, as do loans to financial counter-parties that mature in less than six months and secured lending transactions with financial-sector entities secured by assets other than rehypothecatable level 1 liquid assets that mature within six months.
- A fifty percent RSF factor applies to unencumbered level 2B liquid assets of all maturities, most loans to non-financial wholesale counterparties and certain retail loans with remaining maturities of less than one year, and operational-deposit placements. All other assets that mature in less than one year not otherwise addressed above also receive this factor.
- A 65 percent RSF factor covers most loans with maturities over one year other than operational-deposit placements. This covers mortgages that receive no higher than a fifty percent risk weighting under the capital rules and to loans that receive no more than a twenty percent risk weighting but are not extended to a financial company.[12] This recognition of credit risk is otherwise absent from most of the final NSFR rule, although it tracks Basel's approach for these assets.
- An 85 percent factor applies to all other retail mortgages and all other loans to non-financial sector counterparties, as well as to publicly-traded common equity shares not HQLA, other non-HQLA securities that mature in one year or more, and certain commodities. Minimum credit-card balances due are considered contractual short-term obligations and receive a fifty percent factor when there is a liquid market.
- The most costly 100 percent RSF factor applies to all performing assets not described above, with clients advised to refer to applicable tables to ensure that details are considered. Assets here include loans to financial institutions that mature in one year or more, assets deducted from regulatory capital, equity shares not traded on a public exchange, unposted debits, and certain trade date receivables. Further, regardless of the above, assets that are past due by ninety days or on nonaccrual status fall into this category. The final rule also includes details on the treatment of certain off-balance sheet assets.

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

F. Derivatives Transactions

Three components define these RSF factors: current net value derivatives assets and liabilities, taking variation margin into account even if not sufficient to net the full exposures; initial margin and assets contributed to CCP loss-sharing funds; and potential future derivatives valuation changes. In another change from the NPR, a covered company may take into account variation margin received in the form of rehypothecatable level 1 liquid asset securities. Various RSFs detailed in the final rule apply based on these components and related considerations. An RSF factor also applies to aggregate derivatives exposures.

Assets held in segregated accounts required by law and rule are not considered to be encumbered.

G. Disclosures

The final rule varies from the NPR by requiring semi-annual, not quarterly, NSFR disclosures. Banks are, however, told to monitor their funding profile on an ongoing basis, with shortfalls reported to regulators as noted above. Simple daily averages, not quarter-end results, will be disclosed to prevent window dressing, with the disclosures generally following the Basel Committee's template.

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