BCBS Issues Final Net Stable Funding Ratio Standard

Executive Summary

The Basel Committee on Banking Supervision ("BCBS" or "Basel Committee") issued its final standard on October 31, 2014, requiring banks to maintain a stable funding profile in relation to their on- and off-balance sheet activities. Entitled *Basel III: the net stable funding ratio* ("NSFR" or "standard"), the global standard aims to reduce the likelihood that disruptions to a bank's regular sources of funding will erode its liquidity position, thereby potentially increasing the risk of its failure that, in turn, could lead to broader systemic stress. The NSFR is defined as the amount of "available stable funding" relative to the amount of "required stable funding." Under the final standard, this ratio should be no less than 100 percent on an ongoing basis.

$$\frac{\textbf{Available amount of stable funding}}{\textbf{Required amount of stable funding}} \geq \textbf{100 percent}$$

Available stable funding refers to the portion of capital and liabilities expected to be reliable over the one-year time horizon considered by the NSFR. The amount of stable funding required of a bank is a function of the liquidity characteristics and residual maturities of its assets and off-balance sheet exposures. The final standard retains the structure of the Basel Committee's January 2014 consultative proposal, but includes the following key changes for the required stable funding of short-term exposures to banks and other financial institutions, derivatives exposures, and assets posted as initial margin for derivatives contracts:

- Unencumbered loans to financial institutions with residual maturities of less than six months, where the loan is secured against Level 1 assets and the bank has the ability to freely rehypothecate the received collateral for the life of the loan will receive a 10 percent weighting, while all other unencumbered loans to financial institutions will receive a15 percent weighting;
- NSFR derivative assets net of NSFR derivative liabilities, if the NSFR derivative assets exceed NSFR derivative liabilities, will received a 100 percent weighting; and
- Cash, securities, or other assets posted as initial margin for derivative contracts and cash, or other assets, provided to contribute to the default fund of a central counterparty will receive an 85 percent weighting.

In addition, the final standard recognizes that, under certain strict conditions subject to the discretion of national supervisors, certain asset and liability items are interdependent and can therefore be viewed as neutral in terms of the NSFR.

The NSFR will become a minimum international standard by January 1, 2018.

Background

The global financial crisis revealed certain vulnerabilities related to banks' management of their funding liquidity risk that ultimately impacted the stability of the broader financial system. The balance sheet structures of banks, combined with an increasing reliance on short-term wholesale funding to supplement demand deposits, proved to be susceptible to client and investor runs. Subsequent contractions in the wholesale funding markets exacerbated these risks, as banks invested more of these funds in mismatched assets that became effectively illiquid in times of market stress.

To address these funding liquidity concerns, the BCBS issued two quantitative standards in December 2010, the Liquidity Coverage Ratio ("Basel III LCR") and the NSFR, under its Basel III regulatory framework. These standards were developed to achieve two separate, but complementary objectives. The Basel III LCR was developed to promote short-term resilience of a bank's liquidity risk profile by ensuring that the bank has sufficient high-quality liquid assets ("HQLA") to survive a significant stress scenario lasting for one month. The NSFR was developed to promote resilience over a longer, one-year time horizon by creating additional incentives for banks to fund their activities with more stable sources of funding on an ongoing basis.

The Basel III LCR standard, entitled *Basel III: the Liquidity Coverage Ratio and liquidity risk monitoring tools*, was finalized by the BCBS in January 2013. The BCBS issued a proposal for industry comment to revise its original NSFR standard in January 2014. Under this standard, the average NSFR for large, internationally active banks who participated in the most recent quantitative impact study on bank readiness to meet the Basel III standards was 111 percent as of December 2013. Seventy-eight percent of these banks reported an NSFR that met or exceeded 100 percent, showing that, while banks have made substantial progress, further actions may be required for some banks.[1]

In September 2014, the Federal Reserve Board, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation jointly released a final rule implementing the Basel III LCR in the United States ("U.S. LCR").[2] In its final form, the U.S. LCR requires that, on a consolidated basis, a company's "unencumbered high-quality liquid assets" must be greater than or equal to 100 percent of its "total net cash outflows" over a prospective 30-calendar-day period. The U.S. LCR final rule is considered to be more stringent than the Basel III LCR, due to its restrictions on the range of assets qualifying as unencumbered HQLA, assumed rate of outflows of certain kinds of funding, and shorter transition period to full implementation.

Description

Definitions and Minimum Requirements

The final standard provided some relief to banks relative to the January 2014 proposed NSFR standard. Under the final standard, the NSFR is defined as the

[1] See *Implementation of Basel standards: A report to G20 Leaders on implementation of the Basel III regulatory reforms*, BCBS, November 2014.
[2] See *KPMG Regulatory Practice Letter 14-13*.

amount of "available stable funding" relative to the amount of "required stable funding," which should be greater than or equal to 100 percent on an ongoing basis.

Available Stable Funding (NSFR Numerator)

Available stable funding ("ASF") is defined as the portion of capital and liabilities expected to be reliable over a one-year time horizon. The final standard establishes a tiered structure based on categories assigned to specific liability and capital instruments to be used when calculating a bank's total amount of ASF. The amount assigned to each ASF category is then multiplied by a prescribed ASF factor. The available amount of stable funding is the sum of these weighted amounts.

Summary of liability and capital instrument categories and associated ASF factors		
ASF factor	**Components of the ASF category**	**Modifications from the proposed NSFR standard**
100 percent	• Total regulatory capital before applying capital deductions, excluding Tier 2 instruments with residual maturity of less than one year; • Other capital instruments with effective residual maturity of at least one year, excluding any instruments with explicit or embedded options that, if exercised, would reduce the expected maturity to less than one year; and • Secured and unsecured borrowings and liabilities (including term deposits) with effective residual maturity of at least one year. ➢ Cash flows below the one-year horizon, but arising from liabilities with a final maturity greater than one year do not qualify to receive the 100 percent ASF factor.	• No change.
95 percent	• "Stable" non-maturity (demand) deposits and term deposits with residual maturity of less than one year provided by retail and **small business** customers.	• The final standard changes the borrower base from "small- and medium-sized entity (SME)" to "small business" customers.[3]
90 percent	• "Less stable" non-maturity (demand) deposits and term deposits with residual maturity of less than one year provided by retail and **small business** customers.	• The final standard changes the borrower base from "small- and medium-sized entity (SME)" to "small business" customers.[4]
50 percent	• Secured and unsecured funding with a residual maturity of less than one year provided by non-financial corporate customers; • Operational deposits; • Funding with residual maturity of less than one year from sovereigns, public sector entities ("PSEs"), and multilateral and national development banks; and	• No change.

[3] The proposed NSFR standard defined SME borrowers as "corporate exposures where the reported sales for the consolidated group of which the firm is a part is less than €50 million" under paragraph 273 of the Basel II regulatory framework. The final standard defines small business customers as "loans extended to small businesses in paragraph 231 of the Basel II framework that are managed as retail exposures and are generally considered as having similar liquidity risk characteristics to retail accounts, provided the total aggregated funding raised from one small business customer is less than €1 million (on a consolidated basis where applicable)" under paragraphs 90 and 91 of the LCR standard.

[4] Ibid.

Summary of liability and capital instrument categories and associated ASF factors		
ASF factor	**Components of the ASF category**	**Modifications from the proposed NSFR standard**
	• Other secured and unsecured funding with residual maturity between six months and less than one year, including funding from central banks and financial institutions.	
0 percent	• All other liabilities and equity categories, including other funding with residual maturity of less than six months from central banks and financial institutions; • Other liabilities without a stated maturity, including short and open maturity positions. However, the final standard recognizes two exceptions for liabilities that would be assigned either a 100 percent ASF factor, if the effective maturity is at least one year, or a 50 percent factor, if the effective maturity is between six months and less than one year: ➢ Deferred tax liabilities, which should be treated according to the nearest possible date on which they could be realized; and ➢ Minority interest, which should be treated according to the term of the instrument, usually in perpetuity; • **NSFR derivative liabilities net of NSFR derivative assets, if NSFR derivative liabilities are greater than NSFR derivative assets**; and • **"Trade date" payables arising from purchases of financial instruments, foreign currencies, and commodities.**	• The final standard (1) changes the "derivatives payable net of derivatives receivable if payables are greater than receivables" component to "NSFR derivative liabilities net of NSFR derivative assets if NSFR derivative liabilities are greater than NSFR derivative assets" and (2) adds a trade date payables component, complementing the trade date receivables component added under the RSF denominator.

Required Stable Funding (NSFR Denominator)

The amount of stable funding required of a bank is defined in the final standard as a function of the liquidity characteristics and residual maturities of the various assets held by that bank as well as those of its off-balance sheet exposures. The amount of required stable funding ("RSF") is calculated by assigning the carrying value of a bank's assets to a specific asset category and multiplying it by its associated RSF factor. The total RSF is the sum of the weighted amounts added to the amount of off-balance sheet activity, or potential liquidity exposure, multiplied by its associated RSF factor.

Summary of asset categories and associated RSF factors		
RSF factor	**Components of the RSF category**	**Modifications from the proposed NSFR standard**
0 percent	• Coins and banknotes immediately available to meet obligations; • All central bank required and excess reserves; • **All claims on central banks with residual maturities of less than six months**; and • **"Trade date" receivables arising from the sale of financial instruments, foreign currencies, and commodities**.	• The final standard (1) removes the "all unencumbered loans to banks subject to prudential supervision (including interbank placements) with residual maturities of less than six months" component, (2) adds a "claims on central banks with residual maturities of less than six months" component, and (3) adds a trade date receivables component,

Summary of asset categories and associated RSF factors		
RSF factor	**Components of the RSF category**	**Modifications from the proposed NSFR standard**
		complementing the trade date payables component added under the ASF numerator.
5 percent	• Unencumbered Level 1 assets,[5] excluding coins, banknotes, and central bank reserves.	• No change.
10 percent	• **Unencumbered loans to financial institutions with residual maturities of less than six months, where the loan is secured against Level 1 assets and the bank has the ability to freely rehypothecate the received collateral for the life of the loan.**	• The final standard introduces a demarcation of 10 percent for unencumbered loans to financial institutions meeting certain conditions.
15 percent	• **All other unencumbered loans to financial institutions not covered in the above categories with residual maturities of less than six months** and • Unencumbered Level 2A assets.[6]	• The final standard assigns a 15 percent RSF factor for unencumbered loans to financial institutions not meeting the requirements for a 10 percent weighting.
50 percent	• Unencumbered Level 2B assets;[7] • HQLA encumbered for a period between six months and less than one year; • Loans to **financial institutions and central banks** with residual maturities between six months and less than one year; • Deposits held at other financial institutions for operational purposes; and • All other assets not covered in the above categories with residual maturity of less than one year, including loans to non-financial corporate clients, loans to retail and small business customers, and loans to sovereigns and PSEs.	• The final standard (1) replaces the loans to "banks subject to prudential supervision with residual maturities between six months and less than one year" component with loans to "financial institutions and central banks with residual maturities between six months and less than one year" and (2) removes "non-bank financial institutions" and "central banks" from the "all other assets with residual maturity of less than one year" component.
65 percent	• Unencumbered residential mortgages with a residual maturity of at least one year and with a risk weight of no more than 35 percent under the Basel II credit risk standardized approach ("SA") and • Other unencumbered loans not covered in the above categories, excluding loans to financial institutions, with a residual maturity of at least one year and with a risk weight of no more than 35 percent under the SA.	• No change.
85 percent	• **Cash, securities, or other assets posted as initial margin for derivative contracts and cash, or other assets, provided to contribute to the default fund of a central counterparty**;	• The final standard adds (1) a "cash, securities, or other assets posted as initial margin for derivative contracts and cash, or other assets, provided to

[5] Level 1 assets include, for example, cash, central bank reserves, and certain marketable securities backed by sovereigns and central banks.
[6] Level 2A assets include, for example, marketable securities backed by sovereigns and central banks, covered bonds, and higher rated corporate debt securities (including commercial paper) that meet certain conditions.
[7] Level 2B assets include, for example, lower rated corporate debt securities (including commercial paper), residential mortgage backed securities, and common equities that meet certain conditions.

Summary of asset categories and associated RSF factors		
RSF factor	**Components of the RSF category**	**Modifications from the proposed NSFR standard**
	• Other unencumbered performing loans with risk weights greater than 35 percent under the SA and residual maturities of at least one year, excluding loans to financial institutions; • Unencumbered securities that are not in default and do not qualify as HQLA according to the LCR **with a remaining maturity of at least one year** and exchange-traded equities; and • Physical traded commodities, including gold.	contribute to the default fund of a central counterparty" component and (2) language specifying a remaining maturity of at least one year for unencumbered securities not in default and not qualifying as HQLA.
100 percent	• All assets that are encumbered for a period of at least one year; • **NSFR derivative assets net of NSFR derivative liabilities, if the NSFR derivative assets are greater than NSFR derivative liabilities**; • **20 percent of derivative liabilities (i.e., negative replacement cost amounts) as calculated under the final standard, before deducting variation margin posted;**[8] and • All other assets not covered in the above categories, including non-performing loans, loans to financial institutions with a residual maturity of one year or more, non-exchange-traded equities, fixed assets, **items deducted from regulatory capital**, retained interest, insurance assets, subsidiary interests, and defaulted securities.	• The final standard (1) changes the "derivatives receivable net of derivatives payable if receivables are greater" component to "NSFR derivative assets net of NSFR derivative liabilities, if the NSFR derivative assets are greater than NSFR derivative liabilities," (2) introduces a "20 percent of derivative liabilities" component, and (3) replaces "pension assets, intangibles, and deferred tax assets" with "items deducted from regulatory capital" for all assets not covered under the other categories.

Commentary

In announcing the release of the final NSFR, Stefan Ingves, Chairman of the Basel Committee and Governor Sveriges Riksbank stated, "The Committee has essentially completed its regulatory reform agenda, undertaken to promote a more resilient banking sector following the financial crisis."

While the final standard consists primarily of internationally agreed-upon definitions and harmonized calibrations, the BCBS notes that some elements remain subject to national discretion to reflect jurisdiction-specific conditions. For example, the final standard provides regulators with some latitude to determine whether certain assets and liabilities are interdependent such that the liability cannot fall due while the asset remains on the balance sheet, the principal payment flows from the asset cannot be used for something other than repaying the liability, and the liability cannot be used to

[8] Under the final standard, derivative liabilities are calculated first based on the replacement cost for the derivative contracts (obtained by marking to market) where the contract has a negative value. When an eligible bilateral netting contract is in place that meets certain conditions specified under the Basel III leverage ratio framework and disclosure requirements, the replacement cost for the set of derivative exposures covered by the contract will be the net replacement cost. In calculating NSFR derivative liabilities, collateral posted in the form of variation margin in connection with derivative contracts, regardless of the asset type, must be deducted from the negative replacement cost amount.

fund other assets. In these instances, national supervisors have the discretion to adjust the ASF and RSF factors to 0 percent.

Similar to the U.S. implementation of the Basel III LCR, it is likely that the U.S. implementation of the NSFR will be generally consistent with the international NSFR standard. A key question that remains, however, is whether the U.S. NSFR will apply to a broader scope of institutions than required under the Basel III standard. Regardless, banks currently building out their capabilities for the U.S. LCR requirements should consider identifying the interrelationships between its data standards and those of the NSFR in their systems and processes as they begin preparing for promulgation of the NSFR in the United States (i.e., a Notice of Proposed Rulemaking ("NPR") and Final Rule).

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