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CLIENT ALERT

Net Stable Funding Ratio: Liquidity Risk Measurement Standards and Disclosure Requirements – Notice of Proposed Rulemaking

Federal banking regulators continue to ramp up scrutiny of liquidity risks at financial institutions. On May 3, 2016, Federal banking agencies took a large step towards more closely monitoring and regulating the liquidity positions of financial institutions by moving forward with a proposed rule to implement the Net Stable Funding Ratio (NSFR) for large and internationally active banking organizations.[1] The action follows the Financial Stability Oversight Council's (FSOC) release on Thursday, April 21, 2016 urging regulatory action to address liquidity issues faced by managers of pooled investment funds, separately managed accounts, and hedge funds. The action comes at a time when policymakers and market participants continue to assess shifting liquidity levels in bond markets and differences in cross-border implementation of post-crisis regulatory policies.

The NSFR proposed rule, follows a recommendation by the Basel Committee on Bank Supervision (BCBS) which has yet to be adopted by foreign counterparts. It holds far reaching implications for both domestic institutions and foreign banking organization (FBOs) doing business in the U.S. as well as asset managers and other non-bank financial institutions deemed systemically significant by the FSOC. The rule, as proposed, would directly impact liquidity risk management practices, regulatory reporting, and resolution planning at financial institutions covered by the rule. It would present direct implications for asset managers and central counterparties who deal with financial institutions covered by the rule. It will also present direct implications for banks with large derivatives books or high levels of repo transactions.

In summary: On May 3, 2016, the Federal Deposit Insurance Corporation (FDIC), the Office of the Comptroller of the Currency (OCC), and the Federal Reserve Board (FRB) moved forward with a joint proposed rule that would implement a stable funding requirement, the net stable funding ratio, or NSFR, for large and internationally active banking organizations and would modify certain definitions in the liquidity coverage ratio (LCR) rule[2] that was finalized in September 2014. Comments on the proposed rule will be accepted by each of the agencies through August 5, 2016. The rule follows work by the BCBS designed to strengthen banking organizations' overall risk management, liquidity positions, and liquidity risk management and is intended to be consistent with the net stable funding ratio proposed by the BCBS.[3]

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[1] The proposed rule was first approved at an Open Meeting of the Board of Directors of the Federal Deposit Insurance Corporation on April 26. 2016 and supported by OCC NR 2016-50, "Comptroller Statement Regarding the Proposed Net Stable Funding Rule" (April 26, 2016). The proposed rule was jointly released publicly by the FDIC, OCC, and FRB on May 3, 2016. See OCC NR 2016-52, "Agencies Propose Net Stable Funding Ratio Rule" (May 3. 2016).

[2] "Liquidity Coverage Ratio: Liquidity Risk Measurement Standards," 79 FR 61440 (October 10, 2014), codified at 12 CFR part 50 (OCC), 12 CFR part 249 (Board), and 12 CFR part 329 (FDIC).

[3] See, e.g., Principles for Sound Liquidity Risk Management and Supervision (September 2008), available at http://www.bis.org/publ/bcbs144.htm; Basel III: The Liquidity Coverage Ratio and liquidity risk monitoring tools (January 2013), available at http://www.bis.org/publ/bcbs238.pdf; Basel III: the net stable funding ratio (October 2014), available at http://www.bis.org/bcbs/publ/d295.pdf.

The agencies suggest the proposed NSFR requirement seeks to reduce vulnerability to liquidity risk in financial institution funding structures and promote improved standardization in the measurement, management and disclosure of liquidity risk. It would apply to the same large and internationally active banking organizations that are subject to the LCR rule, but with a broader focus. It seeks to require stable funding relative to each bank's entire balance sheet using a one-year time horizon rather than the LCR's short-term 30-day stress test requirement. Institutions specifically subject to the NSFR include: (1) bank holding companies, savings and loan holding companies without significant commercial or insurance operations, and depository institutions that, in each case, have $250 billion or more in total consolidated assets or $10 billion or more in on-balance sheet foreign exposure, and (2) depository institutions with $10 billion or more in total assets that are consolidated subsidiaries of such bank holding companies and savings and loan holding companies.

The FRB is also proposing to implement a modified version of the NSFR requirement for bank holding companies and savings and loan holding companies without significant insurance or commercial operations that, in each case, have $50 billion or more, but less than $250 billion, in total consolidated assets and less than $10 billion in total on-balance sheet foreign exposure.

The proposed rule would not apply to:

i. Depository institutions with large insurance operations and savings and loan holding companies with large commercial operations;

ii. The U.S. operations of foreign banking organizations or intermediate holding companies required to be formed under the FRB's Regulation YY that do not otherwise meet the requirements to be a covered company (large foreign banking organizations); and

iii. Nonbank financial companies designated by the FSOC for supervision by the FRB (nonbank financial companies).

However, the Federal banking agencies indicate they anticipate implementing an NSFR requirement through a separate rulemaking to cover the U.S. operations of foreign banking organizations with $50 billion or more in combined U.S. assets. They also leave room to implement an NSFR requirement for nonbank financial companies, either collectively or individually, after a period of notice and comment or through an order.

The proposed rule contains an implementation date of January 1, 2018. Public comments on the proposed rule will be accepted through August 5, 2016.

NSFR: The proposed rule would require a banking organization covered by the rule (covered company) to maintain, on an ongoing basis, an amount of available stable funding (ASF) equal to or greater than the amount of its required stable funding (RSF). The NSFR for a covered company would be expressed as the ratio of ASF to RSF. ASF and RSF would be calculated as a weighted measure of the company's available or required funding, respectively. Notification and remediation requirements apply if the NSFR falls below 1.0 to address the Net Stable Funding Ratio Shortfall (NSFR Shortfall).

Available Stable Funding (ASF): The ASF would be calculated by multiplying NSFR regulatory capital elements and NSFR liabilities by a specified ASF factor, expressed as a percentage between 0 and 100 percent (ASF Factor). ASF factors would be assigned to a category of NSFR liability or NSFR regulatory capital element based on the tenor, funding type, and counterparty type of the funding.

Required Stable Funding (RSF): The RSF would represent the minimum level of stable funding that a covered company would be required to hold to support an asset. As with the ASF, the proposed rule would require a covered company to apply a series of factors to its assets, the undrawn amounts of its commitments, and its measures of derivative exposures. The RSF factors would be scaled from 0 to 100 percent and would take into account the credit quality, tenor, type of counterparty, market characteristics, and encumbrance of an asset, undrawn commitment or derivative exposure. For example, assets with longer tenors would be multiplied by a higher RSF factor and require a greater amount of ASF to support the position.

Derivatives: Derivatives transactions would receive special treatment under the proposed rule. Overall, the treatment recognizes netting, margin, and mutualized loss sharing agreements in a manner that continues the post-crisis effort to create incentives to increased derivatives clearing through a central counterparty (CCP). However, it does propose to shift the regulatory focus by requiring stable funding for margin and by assessing derivatives liabilities *before* collateral has been posted. The proposal indicates alternative measures of derivatives volatility are also under consideration, notably including a methodology relying on a company's historical experience.

Asset Transfer Restrictions: The proposed rule would require a banking organization to implement and maintain written procedures to identify and monitor restrictions on transferring assets from its consolidated subsidiaries. This is similar to what regulators have asked Global Systemically Important Banking Organizations (GSIBs) to implement by documenting the types of transactions, such as loans or dividends, a covered company's consolidated subsidiary could use to transfer assets and demonstrating compliance with applicable restrictions. A banking organization would need to demonstrate amounts that can be transferred freely in compliance with statutory, regulatory, contractual, or supervisory restrictions in relevant jurisdictions. This requirement will likely be a significant undertaking for large complex global organizations.

LCR: Importantly, the rule proposed a number of key changes to previously adopted definitions included in the LCR.

i. The proposal significantly narrows the previously adopted definition of a secured funding transaction and tightens the definition of "secured funding" to eliminate illiquid assets, authorizing only liens on securities or loans.

ii. It expands the definition of "operational deposit" to encompass both funding and lending aspects without changing the overall treatment of such deposits.

iii. It invites comment (without making proposals) on how to tighten other material definitional components of the LCR rule, including "collateralized deposits" and "covered non-bank company."

Implications: The regulators acted just after rejecting a substantial number of large bank recovery and resolution plans (commonly referred to as "living wills") and just after the FSOC issued a report highlighting a broad range of liquidity issues on the regulatory agenda regarding the asset management sector. A key pressure point in the living wills context is the extent to which U.S. banks may be adversely impacted by liquidity ring fencing from foreign regulators not only with respect to their own operations but also with respect to the operations of their counterparties.

The NSFR proposal therefore provides indirect insight into how domestic U.S. banking regulators may evaluate liquidity assumptions embedded in recovery and resolution plans submitted by foreign banks and their U.S. intermediate holding companies. Implementation of the NSFR and the embedded shifts in the LCR definitions may also create legal risks for foreign banks whose home country regulators have not taken parallel or equivalent implementation activities. These issues remain under discussion among regulators, with more rule-making targeted exclusively to foreign banks already under discussion according to the proposal. FBOs will need to carefully plan for robust and flexible liquidity risk management practices that can account for differences between domestic and foreign regulatory requirements that are likely to arise at a later date.

In addition, the rulemaking could further accelerate a race for high quality liquid assets amid ongoing shifts in capital market liquidity profiles. Financial institutions subject to the proposed NSFR and LCR will increasingly be in competition with foreign central banks that continue to acquire sovereign bonds that meet the regulatory criteria as "high quality liquid assets." Financial institution appetite for these assets will expand amid a parallel shift towards central clearing for standardized derivatives transactions that are collateralized by high quality liquid assets and ongoing structural shifts in U.S. bond markets.

These shifts and challenges have been expected since the Basel 3 rules were promulgated in 2014. However, they occur amid growing pressures on banks in certain countries from negative interest rates. The implementation of the Basel 3 liquidity risk framework at differing speeds internationally may also increase operational risks for internationally active banks attempting to comply with different liquidity regimes in multiple jurisdictions.

Finally, the proposal would require banking organizations to implement and maintain written procedures to identify and monitor restrictions on transferring assets from consolidated subsidiaries. The proposal thus extends to banking organizations (and, potentially, nonbank institutions subject to FSOC designation for supervision by the FRB) a range of transaction documentation initiatives being implemented by GSIBs. Those initiatives require GSIBs to demonstrate that the amounts in question can be transferred freely in compliance with statutory, regulatory, contractual, or supervisory restrictions in any relevant jurisdiction. Expanding the scope of transaction documentation requirements to the liquidity risk space, while expected, will likely be a significant undertaking for large complex global organizations.

Conclusion: The proposal establishes a quantitative net stable funding ratio for covered companies, intended to ensure the institutions liquidity over the one year time horizon. The NSFR requirement provides regulators with periodic information regarding the funding structure of covered companies and discourages reliance on more volatile, short term funding.

Financial institutions subject to the rule should begin by calculating their net stable funding ratio under the proposed rule to determine if current liquidity and funding profiles present issues under the rule. They should assess net stable funding shortfalls that may exist and put in place plans to obtain additional ASF or reduce RSF in advance of the rule's proposed 2018 implementation date. In addition, financial institutions should begin reviewing and inventorying exposures to central counterparties and other non-bank financial institutions and establish systems to fully capture their impact on ASF and RSF.

How KPMG Can Help

KPMG presents a cross-functional team with deep liquidity risk management knowledge and experience, regulatory insights and broad business knowledge, as well as experienced data and technology professionals with knowledge in system architecture design. KPMG's project management approach monitors engagement progress to keep our engagements on track and stakeholders informed. KPMG brings:

i. Team experience – KPMG offers a powerful combination of professional credentials and engagement experience with proprietary tools and methodologies.

ii. Methodology, tools, and accelerators - KPMG has developed methodologies and accelerators based off industry leading practices to assist in quickly identifying gaps and potential options for enhancement.

iii. Industry and regulatory insights - KPMG's in-depth experience working with a wide variety of financial institutions provides specialized access to market intelligence and a thorough familiarity with liquidity regulatory expectations. We also employ former regulators and industry practitioners who bring their understanding and insights to how regulations are being applied.

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