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Ten key points from Basel's final NSFR

On October 31st, the Basel Committee on Banking Supervision (BCBS) issued its final Net Stable Funding Ratio (NSFR), which was originally introduced by BCBS in 2010 and re-proposed in January 2014. The NSFR compares the amount of a firm's available stable funding (ASF, the ratio's numerator) to its required stable funding (RSF, the ratio's denominator) to measure how the firm's asset base is funded. The NSFR is seen by BCBS as a complement to its previously finalized Liquidity Coverage Ratio (LCR) – recently implemented in the US as a final rule[1] – which is intended to promote short term resilience of a firm's liquidity risk profile.

Overall, the final NSFR remains a fairly crude regulatory tool subject to measurement deficiencies (e.g., potentially imposing different liquidity requirements on practically identical repo transactions) and unintended consequences (e.g., higher transaction costs and instability in deposit markets due to increased demand for deposits that are deemed more stable under the final standard). Despite these weaknesses, and despite changes introduced in the final NSFR that make the standard somewhat more stringent, we expect compliance with the final standard to be manageable for most larger firms.

1. **The final NSFR is manageable**: Industry and BCBS studies indicate that maintaining the NSFR's ratio is workable, at least for larger firms. Under the 2010 proposal, these studies estimated that larger firms would have, on average, met the NSFR at 100% (i.e., obtained a ratio of 1, using 2012 year-end data). This position was subsequently improved by firms' efforts to increase their ASF while keeping their RSF at relatively stable levels,[2] and by changes introduced in the January 2014 re-proposal, resulting in an average NSFR ratio of 1.11 (using 2013 year-end data). We expect the final standard to result in slightly lower ratios across firms, especially due to the final standard's treatment of contributions to central counterparty (CCP) default funds and initial margin for derivatives.
2. **The final standard retains key changes favorable to the industry that were introduced in the January re-proposal**: The January 2014 re-proposal made several key changes to the 2010 proposal, including more favorable treatment of (a) operational, retail, and small business deposits (by assigning higher ASF weightings to these deposits), and (b) retail and small business loans (by assigning lower RSF weightings to these loans). Additionally, the January 2014 re-proposal harmonized the categorization of assets' liquidity under the NSFR with the LCR's High Quality Liquid Asset (HQLA) definitions (by aligning their respective liquidity weightings). These changes were retained in the final NSFR.
3. **However, it is not all good news**: First, despite the industry's lobbying efforts, the final standard continues to include regulatory capital deductions such as goodwill and other intangibles in the RSF, thus keeping the ratio more stringent. Second, the more favorable treatment of operational deposits (that are now subject to a 50% weighting, versus the

[1] See PwC's *First take: Liquidity coverage ratio* (September 9, 2014).

2010 proposal's 0% which would have excluded these deposits from ASF) will still not satisfy those firms that had called for even more favorable weightings for these deposits. Third, under the final standard, practically identical stock borrowing transactions may be assigned different liquidity requirements based on the counterparty's role in the transaction (e.g., initial lender versus intermediary). It will be important to see how these matters are addressed through national direction in implementing the final standard.

4. **Harsher treatment of reverse repos**: The final standard assigns a 10% RSF weighting to short term interbank reverse repos (i.e., those with residual maturities under six months). This represents a shift from the more favorable treatment of these transactions (that are secured by assets categorized as Level 1 HQLA under the LCR), with a 0% RSF weighting under the January re-proposal. However, BCBS's treatment of these transactions is still more favorable than the treatment of other transactions (i.e., those secured by assets categorized as Level 2 HQLA under the LCR) with similar maturities, which are assigned an even higher RSF weighting of 15% under the final standard.
5. **BCBS engineers an alternative treatment for derivatives under the NSFR**: The January re-proposal retained the conservative approach of assigning a 100% RSF weighting to net derivatives assets and a 0% ASF weighting to net derivative liabilities. Derivative assets are valued based on replacement cost or net replacement cost (where an eligible bilateral netting contract exists) with no offset for collateral received, except for cash variation margin. The final standard retains these provisions, and adds to the stringency of this approach by including derivatives liabilities in the RSF with a 20% weighting.
6. **Incorporation of off-balance sheet exposures creates more questions than answers**: The final standard's incorporation of off-balance sheet exposures into the NSFR is a significant change to the January re-proposal. However, the final standard fails to provide adequate clarity around several provisions. For example, under the final standard the undrawn portion of irrevocable (or conditionally revocable) client credit and liquidity facilities are subject to a 5% RSF weighting, but revocability is not defined. The final standard also identifies other off-balance sheet exposures such as revocable facilities and trade finance-related obligations, but delegates the assignment of RSF factors to these items to national supervisors. This level of discretion provided to national supervisors may hinder international harmonization of regulatory standards.
7. **BCBS leaves the door open for improving the toughest measures introduced by the final NSFR**: The final standard assigns a relatively high RSF weighting of 85% to cash, securities, and other assets that are posted as initial margin for derivative contracts or as a contribution to CCP default funds. However, the BCBS has noted that this 85% weighting may be lowered in the future, based on globally emerging regulatory requirements around derivatives margin (or future quantitative impact studies, which are envisioned as a possibility by the final standard).
8. **BCBS calls out national regulators' shortcomings**: The final standard's preamble implicitly calls out supervisors for their failure to assess funding liquidity risks by pointing out firms' failure to comply with the BCBS's 2008 "Principles for Sound Liquidity Risk Management and Supervision." The preamble states that the BCBS will continue to monitor the implementation of these principles at the national level.
9. **US banks should expect to fully comply with both the NSFR and the LCR by January 1, 2018**: The final BCBS standard requires the NSFR to be 100% met as of January 1, 2018, which is aligned with the full phase-in of the US LCR (but is one year earlier than the full phase-in of the BCBS's LCR in January 2019). The BCBS's reluctance to align the two ratios' implementation dates may be due to regulatory concerns regarding short-term wholesale funding or due to the view that the NSFR's ratio is more maintainable that the LCR's.
10. **US NSFR proposal now possible by mid-2015, final rule by 2015 year-end**: The BCBS's early release of the final NSFR makes possible a US proposal for implementing the standard by mid-2015. However, US regulators face a backlog of rulemakings (e.g., G-SIB buffer proposal, final SCCL, and inclusion of municipal securities within the US LCR's definition of HQLA)[3] that will nonetheless challenge a mid-2015 timeline. Foreign banks that must establish US Intermediate Holding Companies (IHCs)[4] will be watching US implementation of the NSFR particularly closely, along with the long-awaited proposal to apply the US LCR to IHCs, because significant differences between US and BCBS liquidity regulations will present operational challenges for foreign banks that have to comply with both regimes.

[2] Based on recent industry studies, the increase in ASF was mainly driven by expansion of firms' deposit base and increases in capital and long-term debt levels. This strategy of increasing ASF while maintaining a stable RSF may lead to unintended consequences as firms to strive meet the required level, e.g., a decrease in long-term lending.

[3] See PwC's *A closer look, US regulatory outlook: The beginning of the end* (July 2014).

[4] See PwC's *Regulatory Brief, Foreign banks: US admission price rising* (July 2014).

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