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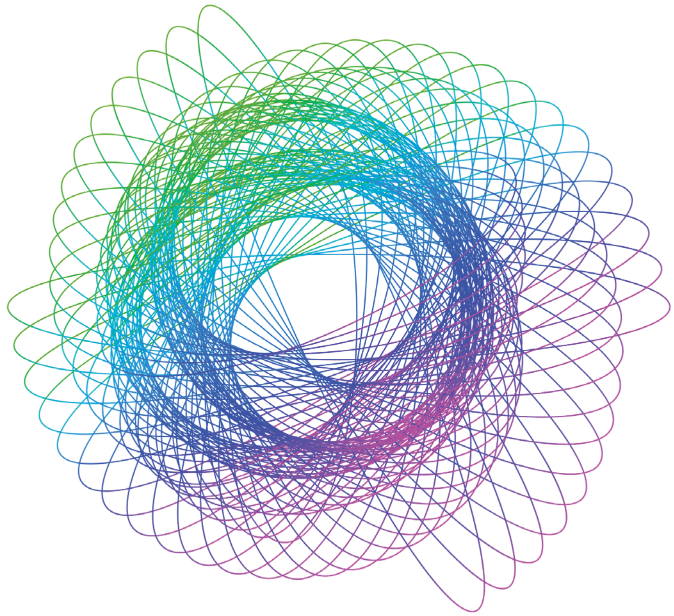

Federal Reserve completes implementation of Basel Liquidity Framework through finalization of the Net Stable Funding Ratio Rule

Overview

On October 20, 2020, the Federal Reserve Board (FRB), the Federal Deposit Insurance Corporation (FDIC) and the Office of the Comptroller of the Currency (OCC), (collectively, the Agencies), issued the final rule for the calculation, reporting, and maintenance of the Net Stable Funding Ratio (NSFR). The NSFR rule is a quantitative liquidity measure of a bank's funding stability whereby a bank's Available Stable Funding (ASF) over a one-year time horizon must be greater than or equal to the Required Stable Funding (RSF) amount as calculated based on the liquidity characteristics of assets, derivative exposures, and commitments over the same period.[1]

The rulemaking completes US regulators' effort to align with the liquidity guidance set forth by the Basel Committee for Banking Supervision (BCBS) in 2013. The NSFR is also complementary to US regulators' short-term liquidity requirements outlined in the Liquidity Coverage Ratio (LCR) Rule[2]. The rule applies to large US and foreign banking organizations and was proposed by the Agencies in May 2016. The rule will become effective on July 1, 2021.[3] As of the second quarter of 2020, all firms subject to the rule have the funding to meet the NSFR requirements.[4]

Differences and key considerations of Final Rule

The final version of the NSFR rule broadly aligns with BCBS standards and is largely unchanged from the 2016 proposal, with a few key exceptions:

The Impact of Tailoring Rules

The final NSFR rule, adopts the institutional categorization tailoring framework introduced as part of the Economic Growth, Regulatory Relief and Consumer Protection Act (EGRRCPA)[5] in 2019 and is aligned to the application of the LCR:

- Category I and II institutions and Category III institutions with short-term wholesale funding (STWF) in excess of $75 billion are subject to full NSFR at 100%.
- Category III institutions not exceeding the STWF threshold are subject to the modified NSFR 85% requirement.
- Category IV institutions are subject to a 70% NSFR requirement if STWF exceeds $50 billion.
- Category IV institutions not exceeding the STWF threshold and depository institution subsidiaries with less than $10 billion in total consolidated assets are not subject to the NSFR requirement.

Foreign Bank Organizations (FBOs) will need to apply this framework to Intermediate Holding Companies (IHCs) while US regulators considers if and how to apply the liquidity standards to the Combined US Operations (CUSO) of FBOs.

Calculation of the Available Stable Funding (ASF) and Required Stable Funding (RSF) Amounts

Changes to the calculation of the ASF and RSF amounts were for the most part made to better reflect the liquidity risk for specific product types and assets classes. Therefore, the proposed rule was revised as follows:

Available Stable Funding (ASF) Calculation

The ASF measures a bank's funding stability through its regulatory capital elements and liabilities. The ASF Funding Factor represents the extent to which the capital element or liability is considered available for use over a one-year time horizon. The ASF factors range from zero (least stable) to 100 percent (most stable) and were determined by considering the tenor of the funding, type of funding, and type of counterparty.[6] Changes from the proposed rules for the ASF calculation are:

- The ASF Funding Factor increased with the revised rule from zero to 50% for retail funding not in the form of deposits (e.g., brokerage payables). The higher available stable funding factor recognizes that these types of funding have a relative degree of stability, similar to other types of funding that receive a 50 percent ASF Funding Factor.
- There is now a 90% ASF Funding Factor for non-insured affiliate sweep deposits and a 95% Funding Factor to certain fully insured affiliate sweep accounts. This change recognizes the enhanced stability of sweep deposits placed by affiliates across a range of market conditions.

Required Stable Funding (RSF) Calculation

The RSF measures the amount of stable funding needed for each firm's assets, commitments, and derivatives. The RSF factors range from zero (most liquid) to 100 percent (least liquid) and were determined by considering the tenor, credit quality, of the funding, type of funding, and type of counterparty, market liquidity, and encumbrances. Changes to RSF Amount Calculation include:

- Reducing the RSF to zero for security holdings of Level 1 liquid assets and for short-term lending with financial institutions secured by Level liquid assets. This change was made to avoid adding constraints on a firm's participation in certain key funding markets (e.g., US treasuries).
- The inclusion of adjustments to the current net value of derivatives for expanded types of variation margin and reducing the required RSF amount for the future value component to better reflect funding risk from derivative portfolios.

Modifications to the Disclosure Requirements

As a whole, the components of the NSFR disclosures are essentially unchanged, however there are a handful of changes that are important to be aware of. They include:

01. The final NSFR rule changed the public disclosure requirement to a semi-annual disclosure from a quarterly disclosure in the proposed rule.
02. The required disclosures include quantitative disclosures of a firm's NSFR and components used to calculate ASF and RSF.
03. The quantitative disclosure is now based on a simple daily average rather than quarter-ending data.
04. The rule now allows firms to assess materiality to determine what qualitative information is "significant", and therefore requiring disclosure.
05. The final rule does not require disclosure of proprietary information but does retain the requirement to provide general information on the exclusion with an explanation.
06. The rule requires the disclosure of qualitative information to support an understanding of the of the disclosed NSFR calculation (e.g., the main drivers of the firm's NSFR).

When preparing disclosures for preparation for compliance with the NSFR rule, firms will need to determine and then document how they're determining what information is considered significant enough to be included as part of the required disclosures.

Proposed Definition Revisions

The proposal included revisions and clarifications to existing definition in the LCR rule, which were adopted as proposed. The revised definitions and clarifications included:

Collateralized deposits – the final rule excluded collateralized deposits from the unwind provision due to their characteristics (collateral requirements set by law) and the stability of the relationship with the depositing entity.

Operational Deposits – operational deposits now include deposits received and placed by the covered company in relation to services provide and received, respectively.

Secured Funding Transaction and Secured Lending – the final rule clarified that securities issued or owned by covered institutions are not to be treated as secured funding transactions.

Unsecured Wholesale Funding – this was revised to mean a liability or general obligation of the covered institution to a wholesale customer or counterparty that is not a secured funding transaction. and the rule now expressly excludes asset exchanges from being considered wholesale funding transactions.

Liquid & Readily Marketable – the final NSFR rule clarified that the Agencies do not expect liquid and readily marketable tests to be performed daily. The refined expectation is to monitor high-quality liquid assets (HQLA) securities on a periodic basis, especially in times of stress, during periods of changing market conditions. Further, the Agencies put forward the expectation that that "they have an appropriate process to regularly review that each security meets the liquid and readily-marketable requirements and that they do in fact perform this analysis".

Operational Requirements for HQLA - the agencies did not accept comments calling for the elimination of the monetization test, reiterating the role that monetization testing play in ensuring the covered institutions access to fund providers and in maintaining effectiveness of the monetization process.

Industry Readiness and Challenges

Firms are now assessing their readiness and may experience challenges in achieving compliance with the final rule, the nature of which will be highly dependent on balance sheet and funding characteristics, bank-specific data management, operational capabilities, and resource availability. The most significant challenges for firms relate to the data needed to calculate the NFSR. This involves identifying the data needed for the calculation and then building the engines to perform the calculation. As with any new rule, the uncertainty of interpretations of the calculations and data requirements will take time to work through.

Banks should start preparing for the implementation and consider the potential challenges, which include:

Reporting specifications, data requirements, operational capabilities, and resourcing impacts

Similar to FR 2052a reporting requirements associated with the LCR, the FRB indicated it would soon issue reporting specifications for NSFR through an update of FR 2052a reporting instructions. Firms shouldbegin evaluating the ability of their current operations to take on the additional burden of calculating the NSFR, including additional requirements in its FR 2052a reporting, and producing disclosures. Since the rule becomes effective at the beginning of the third quarter of 2021, affected firms may face challenges of implementing the reporting changes given the lack of lead time.

Disclosure requirements of the NSFR, such as reporting the 'daily average' NSFR, imply that larger firms will need to produce accurate data on a daily basis as well as preparing for the monthly average calculation based on the daily calculations. In anticipation of the need to define data specifications, firms should perform a pro-forma NSFR calculation using 2052a data.

Disclosure requirements

The application of a materiality standard for defining what is required for the quantitative disclosures does provide more clarity to banks on how to meet regulatory expectations. However, covered institutions will still need to determine what information to disclose and how to address the requirement to convey "general information" on proprietary data with an explanation for its exclusion.

Governance, processes and controls in support of disclosure requirements will need to be integrated into existing frameworks in order determine what is appropriate for the qualitative disclosure. Senior stakeholders (e.g., board risk committees and legal) will need to be involved in reviewing and approving the standards, and controls will be needed to ensure that disclosure completely and accurately captures material/significant information.

Conclusion

NSFR is a firm-wide effort requiring senior management attention and cross-functional cooperation and focus. Banks should align with peers and leading practices to meet regulatory requirements and timelines. As regulators are looking for continuous improvements in reporting instruction and interpretation, banks should view NSFR compliance as an ongoing journey and be ready to manage changes.

This publication is part of an ongoing effort/series to closely monitor and assess how the regulators have responded to risks in financial markets. We will continue to follow developments in this area and issue additional updates and analysis.

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Endnotes

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2. Federal Reserve Board (FRB), "Liquidity Coverage Ratio Press Release" accessed on December 2, 2020.
3. FRB, "Agencies issue final rule to strengthen resilience of large banks," accessed on December 2, 2020.
4. FRB, "Economic Growth, Regulatory Relief and Consumer Protection Act," accessed on December 2, 2020.
5. FRB, "Net Stable Funding Ratio: Liquidity Risk Measurement Standards and Disclosure Requirements," accessed on December 2, 2020. Please note this is taken from the FRB's Board Summary document, p. 5. NSFR numerator.