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Basel III Framework: Net Stable Funding Ratio (Proposed Standards)

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A key new element of the Basel III framework for regulatory capital aims to improve banks' management of their funding and liquidity profiles. Two new measures are proposed: a "net stable funding ratio" and a "liquidity coverage ratio." The net stable funding ratio has received relatively little attention due to its seemingly distant implementation date of 1 January 2018. However, its impact will be immediate and significant for many banking institutions.

The net stable funding ratio ("**NSFR**") aims to ensure that banks hold a minimum amount of stable funding based on the liquidity characteristics of their assets and activities over a one year horizon. The aim is to reduce maturity mismatches between the asset and liability parts of the balance sheet and thereby reduce funding risk. The shorter term liquidity coverage ratio ("**LCR**") requires banks to hold enough liquid assets (such as government bonds) which can, if needed, be converted easily into cash in private markets to survive a 30 day stress scenario. Disclosure requirements for the LCR apply from 1 January 2015, with an incremental phase in to 1 January 2019.

Many of the LCR's details are now finalized. Building on previous liquidity standards, the Basel Committee on Banking Supervision (the "**Basel Committee**") published new standards relating to the LCR on 12 January 2014. *Liquidity Coverage Ratio Disclosure Standards*[1] encourages, among other things, the use of consistent templates for reporting across jurisdictions and a more detailed assessment of banks' high quality liquid assets ("**HQLA**"), concentrations of funding sources, exposures under derivative contracts, and potential collateral calls. Further, the Basel Committee has issued guidance to supervisors[2] in order to assist supervisors in deciding whether different types of liquid assets held by banks are suitable for LCR purposes.

[1] https://www.bis.org/publ/bcbs272.pdf

[2] https://www.bis.org/publ/bcbs273.pdf

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The NSFR works with and counterbalances the cliff edge effects of the LCR, by offsetting incentives to fund liquid assets with short term funding that matures just outside of the LCR's 30 day stress tested period. In broad terms, the NSFR is calculated by dividing a bank's available stable funding ("**ASF**") by its required stable funding ("**RSF**"). The ratio must always be greater than 1. Thus:

$$\boxed{\frac{\textbf{Available stable funding}}{\textbf{Required stable funding}} \geq 100\%}$$

The ASF and RSF requirements specified in the NSFR are adjusted to reflect the degree of stability of liabilities and liquidity of assets. The ASF measure broadly regards the most stable sources of funding to be regulatory capital, funding which has a maturity of at least a year, and deposits. The RSF measure grades various assets in terms of the stable funding required to support them. For example, loans to financial institutions, assets that are encumbered for a period of one year or more, net amounts receivable under derivative trades, non-performing loans, fixed assets, pension assets, intangibles and deferred tax assets require matched stable funding. Residential mortgages would typically require stable funding in the order of 65% of the mortgage amount. Further, certain short-dated assets maturing in less than one year require a smaller proportion of stable funding as banks may allow some proportion of those assets to mature instead of rolling them over. The NSFR also factors in "asset quality" and "liquidity value," recognising that some assets do not require full financing by stable funding where they are securitisable or tradable to secure additional funding. Off-balance sheet commitments and contingencies which create potential calls on liquidity require additional stable funding sources.

In contrast to the LCR, the calibration of the NSFR is still at consultation stage. The Basel Committee has issued a Consultative Document (the "**Consultation**"),[3] issued for comment by 11 April 2014. In most areas, the Consultation does not depart dramatically from the previous Basel III NSFR text and so many pre-existing industry concerns remain.

A summary of the NSFR and its components is set out at the Annex to this Client Publication.

[3] http://www.bis.org/publ/bcbs271.pdf

Key Impacts

i. **<u>Short term compliance costs</u>**: While the NSFR does not come into force for almost five years, market pressure among peers is causing banks to adjust their funding profile to meet basic NSFR requirements ahead of schedule and, as discussed further below, often at significant cost to certain business. Compliance is likely to be particularly challenging in jurisdictions with relatively small retail deposit markets which therefore lack a significant potential source of long-term stable funding.

ii. **<u>"Chilling effect" on long term lending</u>**: Many significant players in long term lending markets, such as aircraft finance, shipping finance and project finance, have announced an intention to withdraw from long-term lending due to increased costs as a result of the NSFR. Liquidity profiles are often adversely impacted by long term, illiquid debt. In project finance, for example, banks who continue to lend in the sector often wish to ensure that loan facilities are transferable without borrower consent, and that transactions are structured to take into account liquidity requirements. As a result of the NSFR, loan tenors have significantly shortened. It is also becoming increasingly common to enter into "mini perm" facilities, which assume a repayment of debt after a limited period of time (typically, five to seven years) through refinancing, but with an amortisation profile extending beyond maturity. Other solutions and trends are likely to emerge as a result of the NSFR, noting the impact on long term lending is abated somewhat by the entry of new lenders into the market (including "shadow-banking" entities), filling the gap left by those who have had to curtail their lending activity as a result of the NSFR.

iii. **<u>Opportunities for arbitrage</u>**: Legal implementation of the NSFR is likely to differ between countries. The Basel Committee recognises that certain national discretions may be permitted subject to these being explicitly and clearly outlined in local rules. Within the EU, the Capital Requirements Regulation ("**CRR**") also permits certain national divergences although the extent to which EU Member States will seek to do so is currently unclear. For example, the Consultation notes that in the calibration of off balance sheet assets, national supervisors are free to specify the relevant weightings for a broad range of products and instruments including: (i) unconditionally revocable credit and liquidity facilities; (ii) trade finance related obligations (including guarantees and letters of credit); and (iii) certain non-contractual obligations such as potential requests for debt repurchases of the bank's own debt, and managed funds that are marketed with the objective of maintaining a stable value.

The Consultation does not represent a radical departure from the pre-existing standards and the industry will continue to express concern over costs and reappraise the viability of certain business lines.

Annex: RSF and ASF Proposed Calibration

1. **Required Stable Funding**: The RSF is a function of the liquidity characteristics and residual maturities of the various assets held by that institution, as well as its off balance sheet exposures. The RSF is calculated by: (i) assigning the carrying value of an institution's capital and liabilities to an "**RSF Category**" based on their residual maturity or liquidity value; (ii) the amount assigned to each category is then multiplied by the required "**RSF Factor**;" and (iii) 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.

RSF FACTOR	RSF CATEGORY[4]
0%	▪ Coins and banknotes ▪ All central bank reserves ▪ Unencumbered loans to banks subject to prudential supervision with residual maturities of less than six months
5%	▪ Unencumbered Level 1 assets, excluding coins, banknotes and central bank reserves
15%	▪ Unencumbered Level 2A assets
50%	▪ Unencumbered Level 2B assets ▪ High quality liquid assets encumbered for a period of six months or more and less than one year ▪ Deposits held at other financial institutions for operational purposes ▪ All other assets not included in the above categories with residual maturity of less than one year, including loans to non-bank financial institutions, loans to NFCs, loans to retail and small business customers, and loans to sovereigns, central banks and public sector entities
65%	▪ Unencumbered residential mortgages with a residual maturity of one year or more and with a risk weight of less than or equal to 35% ▪ Other unencumbered loans not included in the above categories, excluding loans to financial institutions, with a residual maturity of one year or more and with a risk weight of less than or equal to 35% under the Standardised Approach
85%	▪ Other unencumbered performing loans with risk weights greater than 35% under the Standardised Approach and residual maturities of one year or more, excluding loans to financial institutions ▪ Unencumbered securities that are not in default and do not qualify as high quality liquid assets including exchange-traded equities ▪ Physical traded commodities, including gold
100%	▪ All assets that are encumbered for a period of one year or more ▪ Derivatives receivable net of derivatives payable if receivables are greater than payables ▪ All other assets not included 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, pension assets, intangibles, deferred tax assets, retained interest, insurance assets, subsidiary interests, and defaulted securities

Key Differences to Basel III NSFR Text/Comments

- Greater alignment with LCR HQLA definitions
- Lower RSF Factors for unencumbered loans to retail and small business customers. Unencumbered loans with a residual maturity of less than one year to retail and small business customers that do not qualify for a 35% or lower risk weight (under the Standardised Approach to credit risk) were lowered to a 50% RSF Factor from an 85% RSF Factor as previously proposed
- Higher RSF Factors for loans to non-bank financial institutions and non-HQLA securities. Non-renewable loans to non-bank financial institutions and non-HQLA securities with a residual maturity of less than one year did not require any stable funding in the previous proposals but now have a

[4] References to Level 1/2A/2B assets refer to categories of HQLA as set out in the Basel III NSFR text.

RSF FACTOR	RSF CATEGORY[4]
50% RSF Factor ▪ There are now lower RSF Factors for certain other non-HQLA and higher RSF Factors for HQLAs encumbered for a period of six months or more and less than one year ▪ RSF Factor of 50% for interbank lending for a period of six months or more and less than one year (0%, previously)	

2. **Available Stable Funding**: ASF is the portion of capital and liabilities of an institution which is expected to be reliable over a one year horizon. The ASF is calculated by: (i) assigning the carrying value of an institution's capital and liabilities (*i.e.*, the amount at which a liability or equity instrument is recorded before any regulatory deductions, filters or other adjustments) to an "**ASF Category;**" (ii) the amount assigned to each category is then multiplied by the required "**ASF Factor;**" and (iii) the total ASF is the sum of the weighted amounts.

ASF FACTOR	ASF CATEGORY
100%	▪ Total regulatory capital ▪ Other capital instruments and liabilities with effective residual maturity of one year or more
95%	▪ Stable non-maturity (demand) deposits and term deposits with residual maturity of less than one year provided by retail and SME customers
90%	▪ Less stable non-maturity deposits and term deposits with residual maturity of less than one year provided by retail and SME customers
50%	▪ Funding with residual maturity of less than one year provided by non-financial corporate ("NFC") customers ▪ Operational deposits ▪ Funding with residual maturity of less than one year from sovereigns, public sector entities and multilateral and national development banks ▪ Other funding with residual maturity of not less than six months and less than one year not included in the above categories, including funding provided by central banks and financial institutions
0%	▪ All other liabilities and equity not included in the above categories, including liabilities without a stated maturity ▪ Derivatives payable net of derivatives receivable if payables are greater than receivables

Key Differences to Basel III NSFR Text/Comments

- Operational deposits were not recognised in the previous proposal and would have received a 0% ASF Factor, subject to an exception for operational deposits from NFCs
- Secured and unsecured funding maturing in less than one year from NFC customers both receive a 50% ASF Factor and are no longer treated differently. Previously, only unsecured funding from NFCs maturing in less than one year received a 50% ASF Factor and, by implication, secured funding from the same counterparties received a 0% ASF Factor
- Higher ASF Factors are now allocated to stable non-maturity deposits and term deposits. "Stable" non-maturity deposits and term deposits now receive a 95% ASF Factor (previously, 90%). "Less-stable" non-maturity and term deposits now receive a 90% ASF Factor (previously, 80%)
- Additional granularity for liabilities with residual maturities of less than one year is prescribed, with some sources now receiving a 50% ASF Factor (previously, 0%)

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