The Final U.S. Net Stable Funding Ratio: **Six Things To Know**

On October 20, 2020, the federal banking agencies adopted a final rule to implement the net stable funding ratio (“NSFR”), a standardized liquidity requirement that the agencies proposed in May 2016. Once effective on July 1, 2021, the final rule will require certain larger banking institutions to maintain a minimum level of stable funding as measured over a one-year time horizon.

The final rule marks a major regulatory milestone because the NSFR is the final core element of the international Basel III framework to be implemented in the United States. The Basel Committee on Banking Supervision finalized an international NSFR standard in October 2014. In the six years since then, several jurisdictions, including the European Union, have implemented the NSFR, albeit with modifications to the international Basel standard in certain cases. As other jurisdictions have done, the federal banking agencies made a number of targeted changes to the NSFR, particularly with respect to its treatment of capital markets activities, when finalizing the rule.

1 The NSFR is a longer-term standardized liquidity metric that is intended to complement other liquidity requirements.

Designed to measure an institution’s funding stability across a one-year time horizon, the NSFR calculates the ratio of an institution’s available stable funding (“ASF”) amounts (*i.e.*, its equity and debt funding sources) to its required stable funding (“RSF”) amounts (*i.e.*, its assets), with the minimum ratio set at 1.0. Similar to risk weighting in the agencies’ risk-based capital rules, the NSFR assigns RSF and ASF factors to on-balance sheet assets and to regulatory capital and liabilities, respectively, as well as to certain off-balance sheet transactions. Conceptually, the NSFR assigns higher RSF factors to less liquid assets on an institution’s balance sheet, increasing the amount of stable funding required to support those assets, and higher ASF factors to more stable forms of funding (including long-term funding), reflecting the degree to which these liabilities are assumed to provide that support.

The NSFR is intended to complement the liquidity coverage ratio (“LCR”), a short-term liquidity metric that calculates projected cash inflows and outflows over 30 days in a period of stress. Unlike the LCR, the NSFR is not intended to reflect stressed assumptions, but it does include several conservative elements that were a focus of public comments on the 2016 proposal. In addition to the LCR and NSFR, large banking institutions are subject to internal liquidity stress testing and liquidity buffer requirements.

2 The scope of large banking institutions to which the NSFR will apply is consistent with the October 2019 tailoring rules’ categorization scheme.

The final rule applies the NSFR to bank holding companies, covered savings and loan holding companies, and intermediate holding companies of foreign banks based on the categorization of those institutions under the October 2019 tailoring rules, which we previously summarized. The full NSFR requirement applies to (1) Category I institutions, (2) Category II institutions, and (3) Category III institutions that have $75 billion or more in weighted short-term wholesale funding.

A reduced NSFR requirement applies to certain other large banking organizations. Category III institutions with less than $75 billion in weighted short-term wholesale funding are subject to an NSFR requirement calibrated at 85 percent of the full requirement, and a limited subset of Category IV institutions – those with $50 billion or more in weighted short-term wholesale funding – are subject to an NSFR requirement calibrated at 70 percent of the full requirement.

Insured depository institutions with $10 billion or more in assets that are subsidiaries of Category I, II, or III institutions are subject to the NSFR on a standalone basis. Insured depository institution subsidiaries of Category IV institutions are exempt, regardless of their size.

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3 Derivatives transactions are treated less conservatively under the final rule than the agencies had proposed in 2016.

Compared to the 2016 proposal, the final rule includes a number of changes to the RSF and ASF factors assigned to assets and liabilities, mostly in a manner that makes the treatment of capital markets activities less punitive. One of the most significant set of changes is in the NSFR's treatment of derivatives.

As a layer of conservativism and to account for potential future valuation changes in an institution's derivatives book that are not reflected on the institution's balance sheet, the 2016 proposal would have applied a 20 percent "add-on" to the sum of an institution's gross derivatives liabilities, increasing the institution's RSF for those positions. The 20 percent add-on and the rationale for applying it to gross derivatives liabilities were a significant focus of public comment on the proposal. In the final rule, the agencies reduced the calibration of the add-on to 5 percent, but otherwise retained its basic structure. This change is directionally consistent with changes that the European Commission made to its NSFR requirement to reduce the punitive impact of the add-on, though the Commission's adjustments were more complex than simply recalibrating the add-on.

The final rule also omits certain conditions that the 2016 proposal would have imposed for an institution to recognize the effect of variation margin received by the institution in reducing its derivative asset amounts. Specifically, the final rule does not require recognizable variation margin that an institution receives to be in the form of cash in the same currency as the settlement currency or to be the full amount necessary to fully extinguish the net current credit exposure to the counterparty of the derivative. Instead, recognizable variation margin received by the institution may be in the form of cash or rehypothecable Level 1 high quality liquid assets ("HQLA"), so long as the margin (1) is not segregated, (2) is subject to certain netting arrangements, (3) is calculated and transferred on a daily basis based on mark-to-fair value of the derivative contract, and (4) is in one of the governing contract's acceptable settlement currencies.

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4 The final rule includes adjustments that more fully recognize the funding stability of other capital markets activities, including holdings of Treasuries, Treasury-backed repos, and securities brokerage-related assets.

Compared to the 2016 proposal, the final rule includes a number of notable changes to the treatment of capital markets activities:

- ***Level 1 HQLAs.*** Under the final rule, Level 1 HQLAs, such as U.S. Treasury securities, are assigned a 0 percent RSF factor rather than 5 percent as had been proposed.

- ***Repos Backed by Level 1 HQLAs.*** The final rule assigns certain repos a 0 percent RSF factor. Specifically, secured lending transactions with a financial sector entity that mature in less than six months from the calculation date and are secured by rehypothecable Level 1 HQLA receive a 0 percent RSF factor, rather than the 10 percent RSF factor that had been proposed.

- ***Sweep Deposits.*** The final rule assigns a 95 percent ASF factor to affiliate sweep deposits where the entire amount of the sweep deposit is covered by deposit insurance and where the institution has demonstrated to the satisfaction of its primary federal regulator that withdrawal of the deposit is highly unlikely to occur during a liquidity stress event. Affiliate sweep deposits that do not meet all of the requirements to be assigned a 95 percent ASF factor, such as affiliate sweep deposits that are not fully covered by deposit insurance, receive a 90 percent ASF factor. The ASF factors for these two categories of liabilities would have been 90 percent and 50 percent, respectively, in the 2016 proposal. This change recognizes that deposits swept from affiliates are highly stable sources of funding.

- ***Retail Brokerage Payables.*** The final rule assigns a 50 percent ASF factor to a liability owed to a retail customer that is not a deposit or a security, such as retail brokerage payables. The 2016 proposal would have assigned a 0 percent ASF factor to this form of funding.

- ***Unsettled Trades.*** The final rule assigns a 0 percent RSF factor to a trade date receivable due to an institution that results from the sale of a financial instrument, foreign currency, or commodity that is required to settle no later than the market standard for the particular transaction, and that has yet to settle but is not more than five business days past the scheduled settlement date. Other trade date receivables are assigned a 100 percent RSF factor. The 2016 proposal would have provided no leeway for trades that settle using a non-standard settlement period of longer than five days, or that fail to settle on schedule.

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5 Assets arising from participation in Federal Reserve emergency facilities are generally carved out of the NSFR.

The final rule neutralizes the effect of participating in the Federal Reserve's Paycheck Protection Program Liquidity Facility and Money Market Liquidity Facility by excluding assets that secure borrowings from those facilities from an institution's NSFR calculation. As we previously summarized, the agencies provided similar relief in the context of the LCR in May 2020. As with the LCR carveout, the NSFR carveout does not apply to the extent the institution or a consolidated subsidiary issued the securities, debt obligations, or other instruments serving as collateral.

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6 The final rule goes into effect July 1, 2021, but provides a meaningful "seasoning" period before public disclosures are required.

The final rule has an effective date of July 1, 2021. Beginning on that date, institutions will be expected to calculate the NSFR on an ongoing basis and notify their primary federal regulator in the event of any shortfall in the required amount.

The NSFR's disclosure requirements, however, will not begin to apply until periods beginning 18 months after the effective date (*i.e.*, the first quarter of 2023), and disclosures will be semiannual, covering the preceding two quarters. Institutions will therefore make the first set of disclosures in the third quarter of 2023, covering the first two quarters of 2023.

In a change from the 2016 proposal, which would have required institutions to disclose quarter-end figures, the final rule requires disclosure of simple daily averages over a reporting period.

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