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Legal Update
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US Bank Regulators Propose "Net Stable Funding Ratio" Rule to Enhance Financial System Resiliency

The Federal Deposit Insurance Corporation (FDIC), Office of the Comptroller of the Currency (OCC), and Board of Governors of the Federal Reserve System (FRB) (collectively, the Agencies) have approved for public comment a long-anticipated notice of proposed rulemaking (NPR) that would implement for large US banking organizations the net stable funding ratio (NSFR), a quantitative liquidity standard adopted in October 2014 by the Basel Committee on Banking Supervision (BCBS) as part of the "Basel III" regime. The NPR would apply the NSFR to the approximately 15 largest US banking organizations and to their consolidated subsidiaries that are depository institutions with $10 billion or more in total consolidated assets.[1] A modified version of the NSFR would apply to certain depository institution holding companies with assets of at least $50 billion. The NPR would not apply to foreign banking organizations (FBOs), US branches and agencies of FBOs or intermediate holding companies formed by FBOs under FRB's Regulation YY; the FRB intends to initiate a separate rulemaking to develop an NSFR for the US operations of FBOs with $50 billion or more in combined US assets.

Comments on the US NSFR proposal, which fairly closely tracks the BCBS NSFR, are due August 5, 2016. Consistent with the BCBS NSFR standard, the US NSFR would take effect January 1, 2018.[2]

Background. The Agencies view the NSFR as an important complement to other post-financial crisis liquidity-related reforms, including:

- The liquidity coverage ratio (LCR) rule adopted in the US in September 2014, which requires certain large banking organizations to hold a minimum amount of high-quality liquid assets (HQLA) that can be readily converted into cash to meet net cash outflows over a stressed 30-calendar-day period.[3]
- Liquidity risk management and stress testing requirements under the FRB's Regulation YY "enhanced prudential standards" for bank holding companies with total consolidated assets of $50 billion or more in Regulation YY.[4]
- The wholesale funding component under the FRB's risk-based capital surcharge for global systemically important banking organizations (G-SIBs) in the United States.[5]
- The FRB's recently proposed long-term debt and total loss absorbing capacity (TLAC) requirement that would require US G-SIBs and the US operations of certain foreign G-SIBs to have sufficient amounts of equity and eligible long-term debt intended to improve their ability to absorb significant losses and withstand financial stress.[6]

Definition of Covered Companies. The proposed NSFR would apply to the same large and internationally active banking organizations that are subject to the LCR rule (defined as "covered companies"): (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 consolidated assets that are consolidated subsidiaries of such bank holding companies and savings and loan holding companies.

The FRB is also proposing 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 (referred to as "smaller covered companies").[7]

Net Stable Funding Ratio. The NSFR is intended to ensure that a covered company has adequate long-term stable funding, in contrast to the LCR's focus on short-term funding adequacy. The proposed NSFR would require a covered company to maintain an amount of available stable funding (ASF) that is not less than the amount of its required stable funding (RSF) on an ongoing basis. A smaller covered company would be required to maintain an ASF of at least 70 percent of its RSF. A covered company's NSFR would be expressed as a ratio of its ASF amount (the NSFR numerator) to its RSF amount (the NSFR denominator). A covered company's ASF amount would serve as a weighted measure of stability of the company's funding over a one-year time horizon, but not otherwise "stressed" as is the case for the LCR.

A covered company would calculate its ASF amount by applying specified standardized weightings (ASF factors) to its equity and liabilities based on their expected stability. Similarly, a covered company would calculate its RSF amount by applying specified standardized weightings (RSF factors) to its assets, derivative exposures, and commitments based on their liquidity characteristics. These characteristics would include credit quality, tenor, encumbrances, counterparty type, and characteristics of the market in which an asset trades, as applicable.

Available Stable Funding Amount (NSFR Numerator). A covered company's ASF amount would equal the sum of the carrying values of the covered company's NSFR regulatory capital elements (generally, Tier 1 and Tier 2 capital elements) and NSFR liabilities (generally, all other balance sheet liabilities and equity elements), each multiplied by a specified ASF factor. ASF factors would be assigned based on the stability of each category of NSFR liability or NSFR regulatory capital element over the NSFR's one-year time horizon.

A covered company would be able to include in its ASF amount the ASF amount of a consolidated subsidiary only to the extent that the funding of the subsidiary supports the RSF amount associated with its own assets or is readily available to support RSF amounts associated with the assets of the covered company outside the consolidated subsidiary.

ASF Factor Characteristics. The proposed rule would use a set of ASF factors to measure the relative stability of a covered company's NSFR liabilities and NSFR regulatory capital elements over a one-year time horizon. ASF factors would be scaled from zero to 100 percent, with zero percent representing the lowest stability and 100 percent representing the highest stability. Table 1, showing the various ASF factors, is included in Appendix A.

While industry and other market observers have questioned the empirical or other evidentiary basis for the different ASF factors, the proposed rule would assign an ASF factor to a particular

category of NSFR liabilities or NSFR regulatory capital elements based on three characteristics relating to the stability of the funding, as applicable: (i) funding tenor, (ii) funding type, and (iii) counterparty type.

Funding Tenor

The proposed rule would generally treat funding that has a longer effective maturity as more stable than shorter-term funding. The proposed rule would group funding maturities into three categories: (i) less than six months, (ii) six months or more but less than one year, and (iii) one year or more. The proposed rule would treat loans to the covered company with a remaining maturity of one year or more as the most stable (subject to a 100 percent ASF factor), and would treat a loan with a remaining maturity of less than six months or an open maturity as the least stable (subject to a 0 percent ASF factor). The proposed rule would treat a loan from a financial sector or non-financial sector entity that matures in six months or more but less than one year as partially stable (subject to a 50 percent ASF factor).

Funding Type

The proposed rule recognizes that certain types of funding are inherently more stable than other types, independent of stated tenor. For example, the proposed rule would assign a higher ASF factor to stable retail deposits (as defined in the LCR rule) relative to other retail deposits, due in large part to the presence of deposit insurance coverage and other stabilizing features that reduce the likelihood of a depositor discontinuing the funding across a broad range of market conditions. Similarly, the proposed rule would assign a higher ASF factor to operational deposits (unsecured wholesale funding necessary for clearing, custody, or cash management services) than to certain other forms of short-term, wholesale deposits based on the provision of services linked to an operational deposit. Likewise, the proposed rule would assign different ASF factors to different categories of retail brokered deposits based on features that tend to make these forms of deposit more or less stable.

Counterparty Type

The proposed rule would recognize that the stability of a covered company's funding also may vary based on the type of counterparty providing it. Accordingly, the proposed rule would treat most types of funding provided by retail customers or counterparties as more stable than similar types of funding provided by wholesale customers or counterparties. It would also generally treat short-term funding provided by financial sector entities as less stable than similar types of funding provided by non-financial wholesale customers or counterparties.

ASF Consolidation. In general, the proposed rule would require a covered company to calculate its NSFR on a consolidated basis. When calculating ASF amounts available from a consolidated subsidiary, the proposed rule would require a covered company to take into account restrictions on the ASF of the consolidated subsidiary to support assets, derivative exposures, and commitments of the covered company held at entities other than the subsidiary. Specifically, a covered company would only be able to include in its ASF amount any portion of a consolidated subsidiary's "excess" (i.e., ASF amounts in excess of the consolidated subsidiary's RSF amount) to the extent the consolidated subsidiary may transfer assets to the top-tier entity of the covered company, taking into account statutory, regulatory, contractual, or supervisory restrictions. These restrictions may be derived from US law (e.g., Sections 23A and 23B of the Federal Reserve Act) or foreign law (e.g., ring-fencing regimes).

Required Stable Funding Amount (NSFR Denominator). Under the proposed rule, a covered company's RSF amount would represent the minimum level of stable funding that the

covered company would be required to maintain. A covered company's RSF amount would be based on the liquidity characteristics of its assets, derivative exposures, and commitments. In general, the less liquid an asset over the NSFR's one-year time horizon, the greater extent to which the proposed rule would require it to be supported by stable funding. By requiring a covered company to maintain more stable funding to support less liquid assets, the proposed rule is designed to reduce the risk that the covered company could be required to monetize the assets for less than full value, including potentially at fire sale prices, or otherwise in a manner that contributes to disorderly market conditions.

RSF Factor Characteristics. The proposed rule would use a set of standardized weightings, or RSF factors, to determine the amount of stable funding a covered company must maintain. Specifically, a covered company would calculate its RSF amount by multiplying the carrying values of its assets, the undrawn amounts of its commitments, and its measures of derivative exposures by the assigned RSF factors. RSF factors would be scaled from zero percent to 100 percent based on the liquidity characteristics of an asset, commitment, or derivative exposure. Table 2 in Appendix A sets forth the various RSF factors.

Under the proposed rule, a zero percent RSF factor would not require the asset, derivative exposure, or commitment to be supported by ASF and a 100 percent RSF factor would require the asset, commitment, or derivative exposure to be fully supported by ASF. Accordingly, the proposed rule would generally assign a lower RSF factor to more liquid assets, commitments, and exposures and a higher RSF factor to less liquid assets, commitments, and exposures. Interestingly, RSF factors would not be linked to ASF factors, and neither one would be directly linked to the LCR ratio. For example, the LCR rule assumes that a covered company can liquidate all Treasury securities within a 30-day period, while the NSFR assumes that the same covered company can liquidate only 95 percent of its Treasury securities within a one-year time horizon.

For purposes of assigning a specific RSF factor, the proposed rule would measure expected liquidity over the NSFR's one-year time horizon based on the following characteristics, considered collectively for each asset, as applicable: (i) credit quality, (ii) tenor, (iii) type of counterparty, (iv) market characteristics, and (v) encumbrance.

Credit Quality

Credit quality is a factor in an asset's liquidity because the Agencies view market participants as tending to be more willing to purchase higher credit quality assets across a range of market and economic conditions, but especially in a stressed environment (sometimes called "flight to quality"). Thus, demand for higher credit quality assets is more likely to persist and such assets are more likely to have resilient values, allowing a covered company to monetize them more readily.

Assets of lower credit quality, in contrast, are more likely to become delinquent, and that increased credit risk makes these assets less likely to hold their value. As a result, the proposed rule generally would require assets of lower credit quality to be supported by more stable funding to reduce the risk that a covered company may have to monetize the lower credit quality asset at a discount.

Tenor

In general, the proposed rule would require a covered company to maintain more stable funding to support assets that have a longer tenor because of the greater time remaining before the covered company will realize inflows associated with the asset. In addition, assets with a longer tenor may liquidate at a discount because of the increased market and credit risks

associated with cash flows occurring further in the future. Assets with a shorter tenor, in contrast, would require a smaller amount of stable funding under the proposed rule because a covered company would have quicker access to the inflows from these assets. Thus, the proposed rule generally would require less stable funding for shorter-term assets compared to longer-term assets. The proposed rule would divide maturities into three categories for purposes of a covered company's RSF amount calculation: less than six months, six months or more but less than one year, and one year or more.

Counterparty Type

According to the Agencies, a covered company may face pressure to roll over some portion of its assets in order to maintain its franchise value with customers and because a failure to do so could be perceived by market participants as an indicator of financial distress at the covered company.

Typically, this risk is driven by the type of counterparty. For example, the Agencies note that covered companies often consider their lending relationships with a wholesale, non-financial borrower to be important to maintain current business and generate additional business in the future. As a result, a covered company may have concerns about damaging future business prospects if it declines to roll over lending to such a customer for reasons other than a change in the financial condition of the borrower. More broadly, because market participants generally expect a covered company to roll over lending to wholesale, non-financial counterparties based on relationships, a covered company's failure to do so could be perceived as a sign of liquidity stress at the company, which could itself cause such a liquidity stress.

These concerns are less likely to be a factor with respect to financial counterparties because financial counterparties typically have a wider range of alternate funding sources already in place, face lower transaction costs associated with arranging alternate funding, and face less expectation of stable lending relationships with any single provider of credit. Therefore, the Agencies believe that market participants are less likely to assume that the covered company is under financial distress if the covered company declines to roll over funding to a financial sector counterparty. In light of these business and reputational considerations, the proposed rule would require a covered company to more stably fund lending to non-financial counterparties than lending to financial counterparties, all else being equal.

Market Characteristics

Assets that are traded in transparent, standardized markets with large numbers of participants and dedicated intermediaries tend to exhibit a higher degree of reliable liquidity. The proposed rule would, therefore, require less stable funding to support such assets than those traded in markets characterized by information asymmetry and relatively few participants. Depending on the asset class and the market, relevant measures of liquidity may include bid-ask spreads, market size, average trading volume, and price volatility. While no single metric is likely to provide for a complete assessment of market liquidity, multiple indicators taken together provide relevant information about the extent to which a liquid market exists for a particular asset class. For example, market data reviewed by the Agencies show that securities that meet the criteria to qualify as HQLA typically trade with tighter bid-ask spreads than non-HQLA securities and in markets with significantly higher average daily trading volumes, both of which tend to indicate greater liquidity in the markets for HQLA securities.

Encumbrances

Whether and the degree to which an asset is encumbered will dictate the amount of stable

funding that a covered company would be required to maintain to support the particular asset, because encumbered assets cannot be monetized during the period over which they are encumbered. For example, securities that a covered company has pledged for a period of greater than one year in order to provide collateral for its longer-term borrowings are not available for the covered company to monetize in the shorter term. In general, the longer an asset is encumbered, the more stable funding the proposed rule would require. An asset that is encumbered for less than six months from the calculation date therefore would be assigned the same RSF factor as would be assigned to the asset if it were unencumbered.

Derivatives Transactions. The proposed rule would calculate the stable funding requirement and available stable funding relating to a covered company's derivative transactions, as defined in the LCR rule. The calculation includes three components: (1) the current value of a covered company's derivatives assets and liabilities; (2) the initial margin provided by a covered company pursuant to derivative transactions and assets contributed by a covered company to a central counterparty's (CCP's) mutualized loss sharing arrangement in connection with cleared derivative transactions; and (3) potential future changes in the value of a covered company's derivatives portfolio. If the total derivatives asset amount exceeds the total derivatives liability amount, the covered company has an "NSFR derivatives asset amount," which would be assigned a 100 percent RSF factor.

Conversely, if the total derivatives liability amount exceeds the total derivatives asset amount, the covered company has an "NSFR derivatives liability amount," which would not be considered stable funding and would be assigned a zero percent ASF factor. Additionally, the NSFR would apply a 100 percent RSF factor to 20 percent of the derivative liability exposures to account for potential future changes to market values and a 85 percent RSF factor to the fair value of assets contributed by a covered company to a CCP's mutualized loss sharing arrangement as these forms of collateral are assumed to be maintained at levels similar to current levels.

The NSFR would recognize the effect of qualifying master netting arrangements in a similar fashion as the LCR rule. The NSFR would permit covered companies to compute the value of QMNA netting sets prior to applying the NSFR calculation provisions.

Net Stable Funding Ratio Shortfall. The Agencies expect circumstances where a covered company has an NSFR shortfall to arise only rarely. The proposed rule would require a covered company to notify its appropriate Federal banking agency of an NSFR shortfall or potential shortfall, that is, when a covered company's NSFR falls below 1.0.

Specifically, a covered company would be required to notify its appropriate Federal banking agency no later than 10 business days, or such other period as the appropriate Federal banking agency may otherwise require by written notice, following the date that any event has occurred that has caused or would cause the covered company's NSFR to fall below the minimum requirement. In addition, a covered company would be required to develop a plan for remediation in the event of an NSFR shortfall.

The Agencies state that they do not expect covered companies to incur significant costs to comply with the NSFR because the aggregate NSFR shortfall is currently $39 billion. The Agencies believe covered companies can remediate this shortfall prior to the implementation of the NSFR in 2018 by rebalancing their liabilities to favor liabilities with higher ASF factors. According to the Agencies, the expected cost of this rebalancing is $519 million per year. However, this statement is at sharp odds with industry predictions of adverse consequences, including that the "rebalancing" might be accomplished by banks

exiting current lines of business and, when examined in combination with other regulatory reforms, will have significantly higher costs.

Disclosure Requirements. The disclosure requirements of the proposed rule would apply to covered companies that are bank holding companies and savings and loan holding companies and to holding companies subject to the FRB's proposed modified NSFR rule. They would not apply to depository institutions that are subject to the proposed rule.

The proposed rule would require public disclosures of a company's NSFR and its components to be made in a standardized tabular format (NSFR disclosure template). The proposed rule would also require the disclosures to "contain sufficient discussion of certain qualitative features of a company's NSFR and its components to facilitate an understanding of the company's calculation and results." A covered company would be required to provide the public disclosures each calendar quarter in a direct and prominent manner on its public Internet site or in a public financial report or other public regulatory report. The disclosures would have to remain publicly available for at least five years from the date of the disclosure.

Modified NSFR for Smaller Covered Companies. The FRB would apply a modified version of the NSFR to smaller covered companies. Smaller covered companies would use the same ASF and RSF factors and calculations applicable to covered companies, but would need to hold ASF equal to 70 percent of RSF (in contrast to the 100 percent required of covered companies). The modified NSFR would apply only at the holding company level of a smaller covered company.

Comparison with BCBS NSFR. The NPR generally tracks the NSFR standard adopted in October 2014 by the BCBS, with the following exceptions:

- The NPR would require more granular reporting of certain ASF and RSF items (e.g., retail brokered deposits and HQLA categories), but US NSFR disclosures would still be comparable to disclosures made using the BCBS template.
- The NPR would assign a 65 percent RSF to long-term retail mortgage assets that are assigned a risk-weight of no greater than 50 percent under the risk-based capital rules, while the BCBS standard assigns a 65 percent RSF to long-term retail mortgage assets that are assigned a risk-weight of no greater than 35 percent under the risk-based capital rules.
- The NPR would assign an 85 percent RSF to private mortgage-backed securities (MBS), while the BCBS standard assigns a 50 percent RSF to private retail MBS with a credit rating of at least AA. This exclusion from favorable treatment for non-agency MBS appears to be a carry-over from the Agencies' LCR rulemaking.
- The NPR would not permit a covered company to assign an interdependent asset and liability a 0 percent RSF and a 0 percent ASF, which is permitted under the BCBS standard (e.g., certain indirect sovereign lending programs). This is because the Agencies determined that covered companies in the United States do not engage in transactions that would qualify under the BCBA standard.

Conclusion. Comments on the NPR are due not later than August 5, 2016. The Agencies expect to implement the NPR with a January 1, 2018, effective date, which indicates there may be a relatively short window after the final rule is issued for covered companies to implement the necessary compliance programs.

For more information about the topics raised in this Legal Update, please consult your regular Mayer Brown contact or any of the following lawyers.

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Endnotes

[1] Net Stable Funding Ratio: Liquidity Risk Measurement Standards and Disclosure Requirements, *available at* https://fdic.gov/news/board/2016/2016-04-26_notice_dis_c_fr.pdf (FDIC pre-publication version).

[2] BCBS, Basel III: the net stable funding ratio (Oct. 31, 2014); *see* Mayer Brown's Legal Update on the Proposed BCBS NSFR.

[3] Liquidity Coverage Ratio: Liquidity Risk Measurement Standards, 79 Fed. Reg. 61,440 (Oct. 10, 2014); *see* Mayer Brown's Legal Update on the LCR.

[4] Enhanced Prudential Standards for Bank Holding Companies and Foreign Banking Organizations, 79 Fed. Reg. 17,240 (March 27, 2014), *see* Mayer Brown's Legal Update on the Enhanced Prudential Standards.

[5] Implementation of Risk-Based Capital Surcharges for Global Systemically Important Bank Holding Companies, 80 Fed. Reg. 49,082 (Aug. 14, 2015).

[6] Total Loss-Absorbing Capacity, Long-Term Debt, and Clean Holding Company Requirements, 80 Fed. Reg. 74,926 (proposed Nov. 30, 2015).

[7] Unless specifically noted, a smaller covered company would apply the same criteria as a covered company to calculate its NSFR.

Appendix A

Table 1: Summary of ASF Factors

ASF FACTOR	EQUITY AND LIABILITIES ASSIGNED THE ASF FACTOR
100%	• Regulatory capital elements and liabilities with a remaining maturity of one year or more.
95%	• Fully insured stable retail deposits.
90%	• Retail deposits that are neither stable retail deposits nor retail brokered deposits. • Certain more stable retail brokered deposits.
50%	• Unsecured wholesale funding and secured funding transactions with a remaining maturity of less than one year that are provided by wholesale customers that are not financial sector entities or central banks.[1] • Unsecured wholesale funding and secured funding transactions with a remaining maturity of six months or more, but less than one year and that are provided by financial sector entities or central banks. • Securities issued by a covered company with a remaining maturity of six months or more but less than one year. • Operational deposits received by a covered company. • Certain retail brokered deposits with intermediate stability.
0%	• All other funding not described above, including: • Funding (other than operational deposits) where the counterparty is a financial sector entity or a central bank, and the transaction matures within six months. • Retail funding that is not a deposit. • Retail brokered deposits that are not stable. • Derivatives liabilities. • Trade date payables.

[1] Wholesale customers or counterparties that are not financial sector entities or central banks include sovereigns, certain multilateral development banks, public sector entities, and US government-sponsored entities.

Table 2: Summary of RSF Factors[2]

RSF FACTOR	ASSETS AND COMMITMENTS ASSIGNED THE RSF FACTOR
0%	• Reserve Bank balances or other claims on a Reserve Bank that mature within six months. • Claims on a foreign central bank that mature within six months. • Currency, coin, and items in the process of collection. • Trade date receivables.
5%	• Level 1 liquid assets (excluding level 1 liquid assets assigned a zero percent RSF factor), including US Treasury securities. • The undrawn amount of committed credit and liquidity facilities.
10%	• Secured lending transactions (e.g., reverse repurchase transactions) where the counterparty is a financial sector entity and the transactions mature within six months and are secured by level 1 liquid assets.
15%	• Level 2A liquid assets, including certain obligations issued or guaranteed by a US government-sponsored enterprise. • Secured lending transactions where the counterparty is a financial sector entity and the transactions mature within six months and are secured by assets other than level 1 liquid assets. • Unsecured wholesale lending that matures within six months and the counterparty is a financial sector entity.
50%	• Level 2B liquid assets, including certain publicly traded corporate equity and debt securities and US general obligation municipal securities. • Secured lending transactions and unsecured wholesale lending that mature in six months or more, but less than one year, where the counterparty is a financial sector entity or central bank. • Secured lending transactions and unsecured wholesale lending that mature in less than one year, where the counterparty is not a financial sector entity or central bank. • Lending to retail customers or counterparties that matures in less than one year. • Operational deposits placed by a covered company at financial sector entities. • All other assets that mature in less than one year.
65%	• Retail mortgages with a remaining maturity of one year or more that are assigned a risk weight of no greater than 50 percent under the Board's capital regulations. • Other lending that has a remaining maturity of one year or more, is assigned a risk weight of no greater than 20 percent under the Board's capital regulations, and where the borrower is not a financial sector entity.

[2] Table 2 does not include calculation of the derivatives RSF amount.

85%	• Retail mortgages with a remaining maturity of one year or more that are assigned a risk weight of greater than 50 percent under the Board's capital regulations. • Other lending that has a remaining maturity of one year or more and is assigned a risk weight greater than 20 percent under the Board's capital regulations, where the borrower is not a financial sector entity. • Publicly traded common equity shares that are not HQLA. • Other securities that are not HQLA and have a remaining maturity of one year or more. • Traded commodities for which derivative transactions are traded on a US designated contract market or US swap execution facility.
100%	• All other assets not described above, including: • Lending that has a remaining maturity of one year or more, where the borrower is a financial sector entity. • Nonperforming assets. • Equity securities that are not publicly traded. • Commodities that do not qualify to be assigned an 85% RSF factor.

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