PILLAR OF STRENGTH

WHAT DOES THE BASEL III NET STABLE FUNDING RATIO MEAN FOR CORPORATES? RUTH WANDHÖFER EXPLAINS

The most recent revised element of Basel III, which was initially published in 2010 by the Basel Committee on Banking Standards (BCBS), is the net stable funding ratio (NSFR). The final NSFR version was issued in October 2014 (see www.bis.org/bcbs/publ/d295.pdf).

In order to gain an appreciation of the implications of the NSFR, which is the long-term liquidity pillar of Basel III, let us first look at where the NSFR sits within the broader regulatory context of Basel III.

Overview of Basel III

One of the key regulatory responses post crisis has been the development of Basel III, an accord of the BCBS, which has existed since 1988 and been evolving ever since. Basel III covers a revision of existing Basel requirements, such as regulatory capital requirements, and adds two major new elements: the liquidity standards – the liquidity coverage ratio (LCR) and NSFR – and the leverage ratio (LR). Additional capital conservation and countercyclical buffers also apply, according to the Basel III timeline and in line with national regulator decisions.

The revised capital framework requires internationally active banks to hold more and better quality capital, compared to earlier Basel Accords. At the same time, the risk weighting of assets has been subjected to stricter rules translating into yet more capital that has to be held by banks in line with the riskiness of their assets. In addition, global systemically important banks will have to hold additional total loss-absorbing capital of 16-20% of a bank's risk-weighted assets by 2019, subject to the final endorsement of the Financial Stability Board (FSB).

The LR limits banks' ability to pile on assets in relation to their regulatory capital. Tier 1 capital divided by the banks' average total consolidated assets should not exceed 3% (note that the FSB is planning to revise this percentage upwards in 2017).

The LCR has the function to ensure that banks can withstand a 30-day stress scenario by requiring them to hold a sufficiently large buffer composed of eligible liquid assets.

Then we have the NSFR, which has the purpose of supporting banks' long-term stability and resilience by creating a framework for them to hold long-term, stable funding in relation to their assets in order to ensure that funding risk is significantly reduced. The NSFR is applicable to internationally active banks on a consolidated basis (unless otherwise specified by local regulators) and will become binding in January 2018, until which point NSFR quarterly reporting is for monitoring purposes only.

As with all Basel requirements, national legislation will be necessary in order to create legally binding requirements for banks.

All of the above contribute to phenomena such as reduced bank lending; falling bank profitability; increased financial disintermediation; continued bank capitalisation exercises; less bank trading activity and associated reductions of liquidity in the market; increased exposure of banks to sovereigns; limited ability of banks to redistribute financial risk and potential concentration in some asset classes; reduced support for financing international trade; and, ultimately, a transformation of banks' role in the broader economy.

With those high-level consequences in mind, let's take a closer look at the NSFR and how it could impact the corporate client space.

What is the NSFR?

The NSFR specifies two key factors:

1. The available stable funding (ASF) factor, which is the portion of capital and liabilities that is expected to be reliable over the one-year time horizon of the NSFR; and
2. The required stable funding (RSF) factor, which is the amount of stable funding that will be required over the one-year horizon and which is determined by the liquidity characteristics and residual maturities of the assets held by the bank, including off-balance-sheet (OBS) exposures.

In order to determine the ASF and RSF factors, the NSFR outlines key categories of deposit and asset classes and allocates specific percentage factors to these (similar to the concept of 'run-off rates' in the LCR).

In order for banks to comply with the ASF – ie the stability value of the liabilities of the bank – it is important for the ASF to be a high percentage, while the RSF – the degree of necessary long-term funding required in relation to bank assets – should be as low as possible.

As an example, total regulatory bank capital (excluding tier 2 instruments with a residual maturity of less than one year) and other capital instruments and liabilities with a residual maturity of one year or more, have a 100% ASF. This means that these sources of funding are considered stable over the one-year NSFR horizon.

The required stable funding of a specific institution is influenced by the institution's liquidity characteristics and the outstanding maturities of its various assets, including OBS assets. For example, a 0% RSF factor is associated with coins and banknotes, as well as central bank reserves and trade date receivables in relation to sales of financial instruments, foreign currencies or commodities.

There is also a specific treatment of derivative transactions where stricter rules are introduced in relation to derivative netting and collateral requirements. Several aspects of these rules relate back to the LR,

$$\frac{\text{Available stable funding}}{\text{Required stable funding}}$$ to be equal or larger than 100% over the one-year period

which establishes a number of conditions that have to be fulfilled in relation to the ability to net derivatives position. Also, any collateral received in relation to a derivative contract can only be used to offset replacement costs if it is provided as a cash variation margin in line with the LR.

NSFR implications for corporates

When looking at bank activities in the corporate space, both corporate liabilities and assets are clearly identified with specific ASF and RSF factors in the NSFR.

For the ASF side, corporate funding with residual maturity of less than one year, as well as operational deposits (from transaction banking-related activities), receive a 50% ASF factor. As mentioned above, other liabilities with a maturity of over one year receive a 100% ASF. This suggests that corporate deposits that have a time horizon over one year will become very attractive to banks in relation to their NSFR compliance, while deposits with a maturity below one year will become more costly, since only 50% of these deposits will constitute available funding over the NSFR horizon.

On the RSF side, corporate loans have a 50% RSF, meaning that loans extended for a period of less than one year require 50% long-term funding, so they will become more expensive to banks from a funding perspective compared with today. This level of required funding is, for example, a concern for the supply of short-tenor, on-balance-sheet trade finance loans, due to liquidity cost implications. At the same time, loans to corporates that are extended for a period longer than one year will require a 100% RSF.

For OBS items, the NSFR defines a 5% RSF in relation to the currently undrawn proportion of the OBS asset for irrevocable and conditionally revocable credit and liquidity facilities that are extended to any type of client. Meanwhile, other contingent funding obligations are left to national supervisory decisions that specify a particular RSF.

Five things that corporates need to know about NSFR

There are five main conclusions that we can draw for the corporate community in relation to the NSFR.

1) Corporate deposits of less than one-year tenor will become 'less valuable' from an NSFR perspective, which is likely to translate into reduced bank appetite for these types of deposits depending on their overall balance sheet circumstances. This does not mean that term deposits of more than 30 days, which are valuable for banks under the LCR, will cease to exist, but instead banks will now have to balance their strategy across both the LCR and the NSFR.

2) Banks may look, depending on their individual funding requirements, to obtain more corporate deposits with tenors longer than one year, which would give them full funding stability under the NSFR.

3) Long-term loans beyond a one-year horizon will be disincentivised from a bank's perspective, since these will have an RSF factor of 100%.

4) Derivative transactions are expected to become more expensive, given the tighter requirements around netting and collateralisation.

5) Required stable funding requirements will also be applied to the portion of undrawn irrevocable and conditionally revocable credit/liquidity facilities, adding an element of additional funding cost. National variations on implementing the RSF factors for other contingent funding, such as trade finance guarantees and letters of credit, may also add an element of fragmentation between markets with varying associated cost implications for corporates.

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