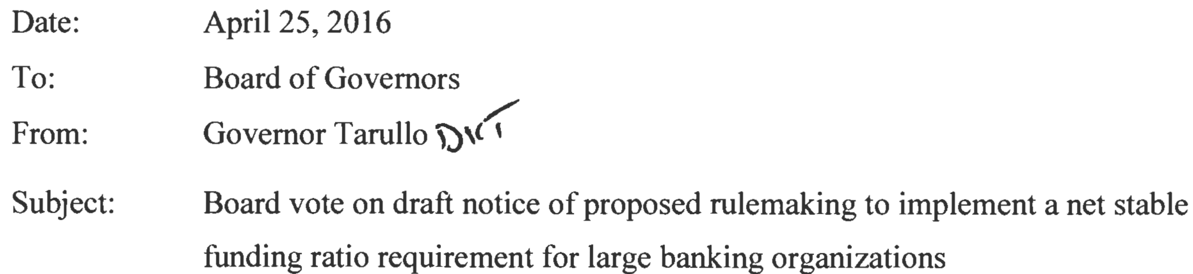
BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM



Date: April 25, 2016

To: Board of Governors

From: Governor Tarullo DKT

Subject: Board vote on draft notice of proposed rulemaking to implement a net stable funding ratio requirement for large banking organizations

Attached are a memorandum to the Board and a draft Federal Register notice of proposed rulemaking (NPR) that would implement a minimum net stable funding ratio (NSFR) requirement for large U.S. banking organizations. This proposal will be considered at an open Board meeting on May 3. The NPR invites public comment on a proposal to require these large U.S. banking organizations to maintain a stable funding structure in relation to the composition of their assets, derivative exposures, and commitments. The proposed NSFR requirement is designed to reduce the likelihood that disruptions to a firm's regular sources of funding will compromise its liquidity position.

The NPR would require a covered company to maintain a stable funding profile over a one-year time horizon, measured by the ratio of its available stable funding amount, calculated based on the stability of its equity and liabilities, to its required stable funding amount, calculated based on liquidity characteristics of its assets, derivative exposures, and commitments. This focus on a longer-term, structural funding profile would complement the liquidity coverage ratio's focus on a 30-day economic and financial stress. The NPR would also require covered companies to publicly disclose certain information about their NSFRs on a quarterly basis.

The proposed NSFR requirement would apply to large and internationally active U.S. banking organizations. A less stringent, modified NSFR requirement would apply to depository institution holding companies with $50 billion or more in total consolidated assets that do not meet the large and internationally active threshold. The proposed NSFR and modified NSFR requirements would become effective January 1, 2018.

The NPR would be issued jointly by the Board, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency after each agency has completed its internal review and approval procedures.

The Committee on Bank Supervision has been briefed on the NPR, and I believe the attached materials are ready for the Board's consideration.

Attachments

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Date: April 25, 2016

To: Board of Governors

From: Staff[1]

Subject: Notice of proposed rulemaking to implement a net stable funding ratio requirement for large banking organizations

ACTIONS REQUESTED: Approval to invite public comment for a period of 90 days on the attached draft notice of proposed rulemaking (the "proposed rule") that would implement a minimum net stable funding ratio (the "NSFR") requirement for large bank holding companies, savings and loan holding companies, and state member banks. The proposed rule would be an enhanced liquidity requirement for bank holding companies that are subject to section 165 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act).[2]

The proposed rule would be issued jointly by the Board, the Federal Deposit Insurance Corporation ("FDIC"), and the Office of the Comptroller of the Currency ("OCC") (collectively, the "agencies") after each agency has completed its internal review and approval procedures.

Staff also requests authority to make technical and minor changes to the attached proposed rule to prepare it for publication in the Federal Register.

EXECUTIVE SUMMARY:

- The proposed rule would implement a minimum stable funding requirement designed to reduce the likelihood that disruptions to a firm's regular sources of funding will compromise its liquidity position. The NSFR requires stable funding over a one-year time horizon and complements the focus on short-term liquidity risk of the Board's liquidity coverage ratio ("LCR") rule.[3] The proposed NSFR requirements would become effective January 1, 2018.
- The proposed rule would require a covered company to maintain a minimum level of stable funding based on the liquidity characteristics of the covered company's assets, funding

[1] Messrs. Gibson, Van Der Weide, and Lindo, Mss. Hewko and Collins, and Messrs. Clifford, Trost, Littler, and Goodrich (Division of Banking Supervision and Regulation), and Mr. Alvarez, Ms. Schaffer, Mr. McDonough, Ms. Stewart, and Messrs. Cohen and Chernoff (Legal Division).

[2] Pub. L. No. 111-203, 124 Stat. 1376, 1423-1432 (2010) § 165, codified at 12 U.S.C. 5365.

[3] 79 FR 61440 (October 10, 2014), codified at 12 CFR part 249.

commitment, and derivative exposures over a one-year time horizon. The requirement would be expressed as a ratio of a covered company's available stable funding to its required stable funding, which must equal at least 1.0 on an ongoing basis.

- The scope of application of the NSFR would be consistent with the scope of application of the LCR. Specifically, the full NSFR requirement would apply to (1) U.S. bank holding companies, savings and loan holding companies without significant insurance or commercial operations, and state member banks with $250 billion or more in total consolidated assets or $10 billion or more in total on-balance sheet foreign exposure, and (2) other state member banks with $10 billion or more in total consolidated assets that are consolidated subsidiaries of the bank holding companies described in (1) (collectively, covered companies).[4]
- A modified NSFR requirement equivalent to 70 percent of the full NSFR requirement would apply to U.S. bank holding companies and savings and loan holding companies without significant insurance or commercial operations that are not covered companies but have $50 billion or more in total consolidated assets (modified NSFR holding companies).
- The proposed rule includes public disclosure requirements for bank holding companies and savings and loan holding companies that would be subject to the NSFR requirement or modified NSFR requirement.
- A covered company would be required to notify the Board when its NSFR falls below the minimum requirement and submit a plan for remediation within prescribed periods of time.
- Covered companies have significantly improved their funding profiles since the 2007-2009 financial crisis. Staff estimates that, if the proposed NSFR requirement and modified NSFR requirement were currently in effect, nearly all covered companies and all modified NSFR holding companies would meet the requirement. Staff estimates that covered companies and modified NSFR holding companies would currently have an aggregate stable funding shortfall of $39 billion, equivalent to 0.5 percent of the aggregate stable funding required across these firms.

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[4] The proposed rule would not apply to nonbank financial companies designated by the Financial Stability Oversight Council (Council) for Board supervision. However, the Board may apply the proposed rule in the future to such companies by separate rule or order.

<u>DISCUSSION</u>: The 2007-2009 financial crisis exposed the vulnerability of banking organizations to liquidity shortages. During the crisis, many banking organizations experienced severe contractions in the supply of available funding and faced the possibility of default or failure. The threat this presented to the U.S. and global financial system caused governments and central banks around the world to provide significant levels of support to these institutions to maintain global financial stability. This experience demonstrated a need for a more rigorous approach to identifying, measuring, monitoring, and limiting reliance by banking organizations on less stable funding sources.

Since the financial crisis, the agencies have implemented or proposed several measures to improve the liquidity positions and risk management of supervised banking organizations. In particular, the Board adopted liquidity risk management and liquidity stress testing requirements for bank holding companies with total consolidated assets of $50 billion or more and the LCR rule, 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 outflow needs over a 30-day time horizon.[5]

Building on these measures, the proposed NSFR requirement focuses on the longer-term, structural funding profile of a covered company, thereby complementing the LCR rule's focus on short-term economic and financial stress. The proposed requirement is designed to reduce the likelihood that disruptions to a banking organization's regular sources of funding will compromise its liquidity position and to promote improvements in the measurement and management of liquidity risk. As a result, the proposed rule would strengthen the safety and soundness of covered companies and the resilience of the financial system.

The proposed rule would be consistent with the net stable funding ratio standard issued by the Basel Committee on Banking Supervision ("BCBS") in October 2014.[6] The proposed

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[5] <u>See</u> "Enhanced Prudential Standards for Bank Holding Companies and Foreign Banking Organizations," 79 FR 17240 (March 27, 2014), codified at 12 CFR part 252, and "Liquidity Coverage Ratio: Liquidity Risk Measurement Standards," 79 FR 61440 (October 10, 2014), codified at 12 CFR part 249.

[6] "Basel III: the net stable funding ratio" (October 2014), available at http://www.bis.org/bcbs/publ/d295.pdf.

rule's public disclosure requirements would be consistent with the net stable funding ratio disclosure standards issued by the BCBS in June 2015.[7]

A. Minimum Requirements

The proposed rule would establish a quantitative requirement, the NSFR, to measure the stability of a covered company's funding profile. Under the requirement, a covered company would calculate a weighted measure of the stability of its equity and liabilities over a one-year time horizon (its available stable funding amount or ASF amount). The proposed rule would require a covered company's ASF amount to be greater than or equal to a minimum level of stable funding (its required stable funding amount or RSF amount) calculated based on the liquidity characteristics of its assets, derivative exposures, and commitments over the same one-year time horizon.

A covered company's NSFR would equal the ratio of its ASF amount to its RSF amount, and a covered company would be required to maintain an NSFR of at least 1.0 (100 percent) on an ongoing basis. Given their size, complexity, scope of activities, and interconnectedness, unstably funded covered companies face an increased likelihood that disruptions to their regular sources of funding will compromise their liquidity positions and contribute to financial instability in the broader economy. The NSFR would help identify a covered company that has a heightened liquidity risk profile and poses greater risk to U.S. financial stability, and allow the Board to require the covered company to take steps to improve its liquidity risk profile and overall resilience. (***See Attachment pp. 17-23***)

The proposed NSFR requirement's effective date of January 1, 2018, should provide banking organizations with sufficient time to adjust to the requirements of the proposed rule. Covered companies generally would be able to utilize current financial reporting systems to determine compliance with the requirement.

B. NSFR Numerator - Available stable funding amount

Under the proposed rule, a covered company's ASF amount (the numerator of the NSFR) would measure the stability of its regulatory capital elements and liabilities. A regulatory capital element or liability would be considered less stable if there is a greater likelihood that a covered company would need to repay or replace it during the NSFR's one-year time horizon. A covered

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[7] "Net Stable Funding Ratio disclosure standards" (June 2015), available at http://www.bis.org/bcbs/publ/d324.pdf.

company's ASF amount would equal the sum of the carrying values of its regulatory capital elements and liabilities, each multiplied by an ASF factor appropriate for that capital element or liability. The ASF factors would represent the extent to which the regulatory capital element or liability is considered stable funding over a one-year time horizon, taking into account the tenor of the funding, type of funding, and type of counterparty. ASF factors would be scaled from zero to 100 percent, with more stable regulatory capital elements and liabilities being assigned higher ASF factors. (See Appendix for a summary of ASF factor assignments.) ***(See also Attachment pp. 41-64)***

C. NSFR Denominator - Required stable funding amount

The proposed rule would require a covered company to maintain an ASF amount that equals or exceeds its RSF amount (the denominator of the NSFR). A covered company's RSF amount would be based on the liquidity characteristics of the company's assets, derivative exposures, and commitments. The RSF amount would be the sum of two components: an RSF amount calculated for non-derivative assets and commitments and an RSF amount calculated for derivative transactions.

RSF Amount for Non-Derivative Assets and Commitments

A covered company would determine its RSF amount for non-derivative assets and commitments by adding the carrying values of its assets and the undrawn amounts of its committed credit and liquidity facilities, each multiplied by an assigned RSF factor appropriate for that asset or facility. The RSF factors would be assigned based on the liquidity characteristics of the asset or commitment over a one-year time horizon, taking into account its tenor, credit quality, type of counterparty, market characteristics (such as bid-ask spreads and trading volume), and encumbrances. RSF factors would be scaled from zero to 100 percent, with a lower RSF factor assigned to more liquid assets (and certain commitments) and a higher RSF factor assigned to less liquid assets. (See Appendix for a summary of RSF factor assignments.) Encumbered assets cannot be freely monetized during the period they are encumbered, and therefore the proposed rule would generally require more stable funding for an asset that is encumbered for more than six months. ***(See Attachment pp. 64-101)***

Derivatives RSF Amount

Under the proposed rule, a covered company would calculate its required stable funding relating to its derivative transactions ("derivatives RSF amount") separately from its other assets and commitments. A covered company's derivatives RSF amount would reflect three

components: (1) the current value of a covered company's derivatives assets and liabilities; (2) contributions by a covered company to a central counterparty's ("CCP") default fund in connection with cleared derivative transactions and initial margin provided by a covered company pursuant to cleared or non-cleared derivative transactions; and (3) potential changes in the value of a covered company's derivative transactions. ***(See Attachment pp. 101-121)***

D. NSFR Consolidation Limitations

In general, the proposed rule would require a covered company to calculate its NSFR on a consolidated basis. The proposed rule would, however, require a covered company—when calculating its consolidated ASF amount—to take into account any restrictions on the ability of stable funding of a consolidated subsidiary to support assets, derivative exposures, and commitments outside the subsidiary. Examples of such restrictions include sections 23A and 23B of the Federal Reserve Act[8] and the Board's Regulation W (which limit certain affiliate transactions of a depository institution);[9] any other restrictions imposed on a consolidated subsidiary by state or federal law, such as any restrictions on asset transfers imposed on a regulated insurance company by a state insurance regulator; and any restrictions imposed on a consolidated foreign subsidiary or branch of a U.S. covered company by a foreign regulatory authority (including, for example, requirements to "ring fence" assets located in a particular jurisdiction). This approach to calculating a covered company's consolidated ASF amount under the NSFR would be similar to the approach under the LCR rule to calculating a covered company's HQLA amount. By limiting a covered company from including in its ASF amount funding of a consolidated subsidiary that cannot support assets held outside the subsidiary, the approach would have the effect of preventing a covered company's NSFR from overstating the stability of its funding structure. ***(See Attachment pp. 121-125)***

E. NSFR Shortfall Remediation

In the event a covered company's NSFR falls below the proposed requirement, the covered company would be required to give notice of the shortfall to the Board within 10 business days, unless the Board extends or shortens the reporting period. In addition, the proposed rule would require a covered company to develop a plan for remediation, which it would be required to submit to the Board. Given the range of reasons, both idiosyncratic and

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[8] 12 U.S.C. 371c and 12 U.S.C. 371c-1.

[9] 12 CFR part 223.

systemic, that a covered company could have an NSFR below 100 percent, and to allow firms to address emergency liquidity needs, the proposed rule would not prescribe a particular supervisory response to address a violation of the NSFR requirement. Instead, the proposed rule would allow the Board to respond based on the circumstances of a particular case. Such a response could include a public enforcement action requiring the company to increase its liquidity or an informal supervisory action. ***(See Attachment pp. 127-130)***

F. Definitions

The proposed rule includes revisions to existing definitions in the LCR rule that are applicable to both the LCR rule and the proposed rule, and includes new definitions that would apply only to the proposed rule. The proposed revisions would improve clarity in the LCR rule and allow for common usage in the LCR rule and the proposed rule, and should lessen administrative burdens for companies to comply with the rules. Rather than taking effect on January 1, 2018, along with the NSFR requirement, these definitions would become effective shortly after the Board adopts any final rule. ***(See Attachment pp. 23-33)***

G. Modified NSFR

The proposed rule would apply a less stringent modified NSFR requirement that applies to and is tailored for U.S. bank holding companies and savings and loan holding companies without significant insurance or commercial operations that have $50 billion or more in total consolidated assets but do meet the thresholds to be subject to the full NSFR requirement. These modified NSFR holding companies are smaller banking organizations that are generally less complex in structure, less interconnected with other financial companies, and less reliant on riskier forms of funding. Their activities are more limited in scope and they tend to have simpler balance sheets, which should make it less difficult for a company's management and its supervisors to identify risks and take corrective actions quickly in the event of disruptions to its regular sources of funding.

The modified NSFR requirement reflects the lower level of risk faced and posed by modified NSFR holding companies. The proposed rule would require a modified NSFR holding company to maintain an amount of stable funding equivalent to 70 percent of the amount that would be required for a covered company subject to the full NSFR requirement. A modified NSFR holding company would calculate its RSF amount in the same manner as a covered company, except that a modified NSFR holding company would multiply its RSF amount by 70

percent. Modified NSFR holding companies would otherwise be subject to proposed rule in the same manner as covered companies. ***(See Attachment pp. 130-133)***

H. Public disclosure requirement

The proposed rule would require a bank holding company or savings and loan holding company subject to the proposed NSFR requirement or modified NSFR requirement to publicly disclose its NSFR and certain components of its NSFR in a standardized format. The proposed rule would also require these companies to include qualitative discussion to facilitate an understanding of the company's NSFR calculation and results. Each of these companies would be required to provide timely public disclosures each calendar quarter. These standardized disclosures would enable market participants to compare stable funding characteristics of covered companies in the United States and other banking organizations subject to similar stable funding requirements in other jurisdictions. ***(See Attachment pp. 133-143)***

I. Current NSFR Shortfall and Impact

In developing the draft proposed rule, staff assessed its potential impact, including the extent to which any covered companies or modified NSFR holding companies currently fall short of the proposed NSFR requirement or modified NSFR requirement, respectively, and would need to make balance sheet adjustments, such as reducing short-term funding or increasing holdings of liquid assets, in order to come into compliance.

As of December 2015, 15 depository institution holding companies would be covered companies under the proposed rule and 20 depository institution holding companies would be modified NSFR holding companies. Staff estimates that nearly all of these companies would be in compliance with the applicable proposed NSFR or modified NSFR requirement if it were in effect today. In the aggregate, staff estimates that covered companies and modified NSFR holding companies would face a shortfall of approximately $39 billion, equivalent to 0.5 percent of the aggregate RSF amount that would apply across these firms.

Because nearly all covered companies and modified NSFR holding companies would already be in compliance and because the aggregated ASF shortfall amount would be small relative to the size of these companies, staff does not expect these companies to incur significant costs in connection with making changes to their funding structures to comply with the proposed NSFR requirement.

In terms of benefits, the proposed rule would require firms to maintain balance sheet improvements they have made since the financial crisis, reinforcing the safety and soundness of

the firms and improving the resilience of the financial system to liquidity stress. By enhancing the stability of the financial system, the proposed rule would reduce the likelihood and severity of a financial crisis. Because financial crises can impose substantial costs on the real economy, even a small reduction would have significant benefits. ***(See Attachment pp. 143-152)***

CONCLUSION: Based on the foregoing, staff recommends that the Board approve the attached draft notice of proposed rulemaking with a 90-day public comment period. Staff also requests that the Board delegate to staff the authority to make technical and minor changes to the attached materials to prepare them for publication in the Federal Register.

Attachment

APPENDIX: ASF AND RSF FACTOR SUMMARIES

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.[10] • 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.

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

Table 2: Summary of RSF factors[11]

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 U.S. 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 that 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 U.S. government sponsored enterprise. • Secured lending transactions where the counterparty is a financial sector entity that 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 U.S. 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.
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.

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

RSF Factor	Assets and Commitments Assigned the RSF Factor
	• 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 U.S. designated contract market or U.S. 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.