

# Client Update

## Basel Committee Adopts Net Stable Funding Ratio: How Much Liquidity Is Enough?

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On October 31, 2014, the Basel Committee on Banking Supervision (the “Basel Committee”) released the final Net Stable Funding Ratio (the “NSFR”) framework, which requires banking organizations to maintain stable funding (in the form of various types of liabilities and capital) for their assets and certain off-balance sheet activities. The NSFR finalizes a proposal first published by the Basel Committee in December of 2010 and later revised in January of 2014. Particularly given the historical trend as between the Basel Committee and U.S. banking agency implementation and in line with its Halloween release, it has left many wondering: Is it a trick or a treat?

The NSFR is designed by the Basel Committee to work in conjunction with the Liquidity Coverage Ratio (the “LCR”), finalized by the Basel Committee in January of 2013 and implemented in the U.S. by the Board of Governors of the Federal Reserve (the “Federal Reserve”), the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency (together, the “U.S. Regulators”) in September 2014 (the “U.S. LCR”).<sup>1</sup> While the LCR is designed to promote short-term liquidity resilience by ensuring that affected banking organizations maintain high quality liquid assets to fund their short-term liquidity needs in times of stress, the NSFR aims to reduce funding risk over a longer horizon by requiring affected banking organizations to have available stable sources of funding for their assets and activities.

Both the LCR and the NSFR seek to address concerns that arose during the financial crisis when banking organizations had insufficient liquidity to continue their lending and other operations. By imposing quantitative liquidity requirements on banking organizations, the LCR and the NSFR seek to ensure

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<sup>1</sup> See Debevoise & Plimpton, *Client Update: Questions and Answers on the Liquidity Coverage Ratio* (Sept. 17, 2014), available at <http://www.debevoise.com/insights/publications/2014/09/questions-and-answers-lcr>; see also Lee A. Schneider, *How to Implement Procedures for the LCR Rules*, COMPLIANCE REPORTER (Sept. 22, 2014), available at <http://www.complianceintel.com/Article/3381655/How-To-Implement-Procedures-For-The-LCR-Rules.html>.

that they have sufficient cash and cash equivalents to operate during times of significant stress and market dislocation, thereby reducing the risks associated with those eventualities.

The practical impacts of the two rules, however, have many banks and bank-affiliated broker-dealers (which are indirectly subject to the rule by virtue of their parent bank holding companies being so subject), as well as their customers, concerned about the viability of various businesses, including securities finance, proprietary trading<sup>2</sup> and traditional lending (including margin lending). At the very least, the combined effect of the LCR and the NSFR will likely be increased costs for these and other banking organization functions.

We summarize key aspects of the NSFR in a series of questions and answers below. We also highlight a number of comparison points between the U.S. LCR and the NSFR.

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<sup>2</sup> The Volcker Rule, as incorporated in section 619 of the Dodd-Frank Act, places limits on the proprietary trading activities of banking organizations. In addition to the required stable funding for a banking organization’s outstanding exposures, a banking organization must ensure such exposures meet an applicable exclusion or exemption under the Volcker Rule. 12 U.S.C. § 1851.

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**I. APPLICABILITY AND SCOPE**

**A. To Which Entities Does the NSFR Apply?**

While the Basel Committee’s NSFR must be adopted in a jurisdiction before it applies to such jurisdiction’s banking organizations, the NSFR directs that it should be applied to internationally active banking organizations on a consolidated basis, and may, to ensure consistency and a level playing field, be applied to non-internationally active banking organizations as well. Given the NSFR’s applicability to the consolidated organization, it will impact not only banks, but also affiliated broker-dealers and other subsidiaries.

It may be useful to analogize to the LCR when considering to whom the NSFR will apply when adopted in the U.S. The LCR was given an identical scope to the NSFR by the Basel Committee, and the U.S. Regulators applied (1) a more stringent LCR to bank holding companies and savings and loan holding companies with \$250 billion or more in total consolidated assets, or \$10 billion or more in on-balance sheet foreign exposure and to such entities’ consolidated subsidiary depository institutions with \$10 billion or more in total consolidated assets; and (2) a less stringent LCR to depository institution holding companies (but not to their subsidiary banks) with \$50 billion<sup>3</sup> or more in total consolidated assets that do not meet the thresholds for the more stringent LCR. Nevertheless, we must await the Notice of Proposed Rulemaking from the U.S. regulators to see the breadth of application to banking organizations in the U.S.

**B. When Will the U.S. Regulators Adopt the Version of the NSFR That Will Apply to U.S. Banking Organizations?**

Although, as stated in I.C. below, the NSFR is anticipated to become effective in January 2018, it is unclear when the U.S. Regulators will adopt the NSFR. Federal Reserve Governor Daniel Tarullo has indicated that the Federal Reserve will finalize a proposed rule in 2015,<sup>4</sup> and that the agency anticipates modifying the Basel Committee’s rule before adopting a U.S. version of the NSFR.<sup>5</sup> The proposal, comment and finalization

<sup>3</sup> There are congressional efforts currently under way to raise the \$50 billion threshold, which, if ultimately fruitful, may provide some relief for regional banks.

<sup>4</sup> See Daniel K. Tarullo, Governor of the Federal Reserve, Liquidity Regulation (Nov. 20, 2014), at 5, available at <http://www.federalreserve.gov/newsevents/speech/tarullo20141120a%20.htm>.

<sup>5</sup> See Daniel K. Tarullo, Governor of the Federal Reserve, Dodd-Frank Implementation (Sept. 9, 2014), at 6, available at <http://www.federalreserve.gov/newsevents/testimony/tarullo20140909a.htm> (providing that one of the Federal Reserve’s initiatives to reduce short-term wholesale funding risks includes “proposed modifications to the BCBS’s net stable funding ratio . . . standard to strengthen liquidity requirements that apply when a bank acts as a provider of short-term funding to other market participants”).

period will likely take an extended period. For reference, the original Basel Committee LCR was published in December 2010 with an update in January 2013. The U.S. proposed rule was released on October 24, 2013 and the final rule on September 3, 2014.

### C. What Is the Implementation Time Frame Set by the Basel Committee?

The Basel Committee provides that the NSFR will become a minimum standard by January 1, 2018. For a frame of reference, the Basel Committee's LCR phases in from January 1, 2015 to January 1, 2019, while the "super-equivalent" U.S. LCR is scheduled to be fully implemented by January 1, 2017.

### D. What Are Some Significant Comments Made by U.S. Regulators Concerning the NSFR?

While Governor Tarullo has described the Basel Committee's NSFR as "path-breaking," he has indicated that the Federal Reserve's proposed NSFR will likely include modifications to the Basel Committee's NSFR.<sup>6</sup>

Janet L. Yellen, Chair of the Federal Reserve, also approvingly discussed the NSFR, noting that "requiring firms to use higher levels of stable funding for less liquid assets reduces the vulnerabilities of a firm to structural maturity mismatches," thus reducing the likelihood that such firms will "need government liquidity support in times of stress."<sup>7</sup> She added that the NSFR incentivizes firms to move to more stable funding structures.<sup>8</sup>

Chair Yellen noted that while the NSFR is an "important step[] forward," it and the LCR do not "fully address the financial stability concerns associated with short-term wholesale funding," because the NSFR and the LCR focus on the liquidity positions of individual firms as opposed to the financial system as a whole; apply only to internationally active banks; and do not address "financial stability risks associated with so-called matched books of securities financing transactions."<sup>9</sup> Chair Yellen noted that the Federal Reserve is considering requiring large banking organizations to hold larger amounts of stable funding based on their use of short-term wholesale funding.<sup>10</sup>

Governor Tarullo has discussed the impact of the NSFR on "matched book" securities financing transactions, in which a dealer enters into back-to-back securities borrow/loan transactions in order to loan securities to a client. Governor Tarullo indicated with approval that the proposed NSFR would require banks to hold a material amount of stable funding against short-term securities financing transaction loans to non-bank

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<sup>6</sup> See Daniel K. Tarullo, Governor of the Federal Reserve, Liquidity Regulation (Nov. 20, 2014), at 6, available at <http://www.federalreserve.gov/newsevents/speech/tarullo20141120a%20.htm> (providing that the Federal Reserve is addressing residual risks not covered by the LCR and the NSFR by, *inter alia*, "adding certain requirements in our domestic implementation of the international standards"); see also *supra* note 5 and accompanying text.

<sup>7</sup> Janet L. Yellen, Chair of the Federal Reserve, Opening Remarks at the Federal Reserve Bank of Atlanta's 2014 Markets Conference (Apr. 15, 2014), at 2, available at <http://www.federalreserve.gov/newsevents/speech/yellen20140415a.htm>.

<sup>8</sup> *Id.*

<sup>9</sup> *Id.*

<sup>10</sup> *Id.*

financial entities.<sup>11</sup> Recently, Governor Tarullo provided that the NSFR will begin “to address the risks associated with matched books of securities financing transactions,” explaining that matched books can pose liquidity risks because banking organizations may be reluctant to run off assets to preserve client relationships and because running off assets will create liquidity squeezes for banking organizations’ counterparties.<sup>12</sup> While the interdependent assets and liabilities exception<sup>13</sup> may provide some relief in the case of matched book activity, Governor Tarullo’s statements suggest that the U.S. Regulators may limit the availability or impact of the discretionary exception in a U.S. NSFR rule.

## II. THE GOALS OF THE NSFR AND CONTRAST WITH THE LCR

### A. What Perceived Issue Is the NSFR Trying to Solve?

The 2007-2008 financial crisis, during which market liquidity dried up very quickly, illustrated the rapidity with which banking organizations conceivably can encounter liquidity and funding issues. When a banking organization relies on unstable funding, including short-term funding generally and short-term wholesale funding specifically, the regulators believe its continued ability to conduct business operations may become endangered during times of serious economic stress. The NSFR is intended to ensure that banking organizations have a more stable, longer-term funding profile to support assets and off-balance sheet activities.

### B. How Does the NSFR Seek to Affect a Banking Organization’s Funding Profile?

The NSFR seeks to affect a banking organization’s funding profile by requiring that it obtain and rely more on funding sources determined to be sufficiently stable and longer-term in nature, thus minimizing the potential risks presented to the organization by future funding stress.

### C. How Is the NSFR Calculated?

The NSFR compares a banking organization’s available stable funding (“ASF”) (the numerator) to its required stable funding (“RSF”) (the denominator), requiring ASF to be at least 100% of RSF.

$$\frac{ASF}{RSF} \geq 100\%$$

ASF is calculated by multiplying a banking organization’s liabilities and capital by the percentages, or factors, assigned to them depending on their perceived stability, and then summing the weighted figures. Liabilities

<sup>11</sup> See Daniel K. Tarullo, Governor of the Federal Reserve, Dodd-Frank Implementation (Sept. 9, 2014), at 6, available at <http://www.federalreserve.gov/newsevents/testimony/tarullo20140909a.htm>.

<sup>12</sup> See Daniel K. Tarullo, Governor of the Federal Reserve, Liquidity Regulation (Nov. 20, 2014), at 5-6, available at <http://www.federalreserve.gov/newsevents/speech/tarullo20141120a%20.htm>.

<sup>13</sup> Basel Committee, *Basel III: The Net Stable Funding Ratio* (the “Basel Committee NSFR”) (Oct. 2014), ¶ 45, available at <http://www.bis.org/bcbs/publ/d295.htm> (providing an exception, to be incorporated at the discretion of national regulators, in the case of interdependent assets and liabilities). See *infra* VI.D. for a detailed discussion of the exception.

and capital with higher perceived stability have higher multiplication factors. RSF is calculated by multiplying a banking organization's assets by the factors assigned to them based on their maturity, quality and liquidity value, and then adding the weighted figures. Assets with lower RSF factors tend to have greater liquidity, be of better quality and/or have shorter maturities.

#### **D. Why Are Banking Organizations Subject to Both the LCR and the NSFR?**

While both the LCR and the NSFR are aimed at addressing liquidity risks at banking organizations, each ratio attempts to address a different aspect of these risks, with the LCR directed towards short-term liquidity and the NSFR directed towards longer-term funding risks. The LCR focuses on short-term liquidity needs of a large banking organization over a 30-day time horizon by seeking to ensure that its portfolio of assets includes sufficient amounts of highly liquid assets to satisfy its obligations as they come due during those 30 days. The NSFR focuses on the asset side of a banking organization's balance sheet and seeks to address maturity transformation risk over a longer time horizon by comparing the structure of the bank's sources of funding relative to its perceived funding requirements over that longer period.

#### **E. How Often Do I Have to Calculate the NSFR, as Compared to the LCR?**

While the NSFR does not prescribe how often it must be calculated internally, compliance is required on an ongoing basis and a banking organization's NSFR is to be reported at least quarterly. The Basel Committee anticipates publishing NSFR disclosure standards at year-end. On the other hand, the U.S. LCR requires that banking organizations subject to the more stringent requirements calculate their LCR daily, while banking organizations subject to the less stringent requirements calculate their LCR on a monthly basis.

#### **F. For Certain Categories of ASF and RSF, Treatment Is More Stringent when a Banking Organization's Counterparty Is a Financial Institution. What Is the Definition of "Financial Institution" for this Purpose?**

The NSFR provides that its definitions generally mirror those of the LCR, and that when national supervisors have implemented more stringent definitions in their domestic LCR rules, supervisors have discretion regarding whether to apply such stricter definitions to the NSFR.<sup>14</sup> For purposes of the Basel Committee's LCR, "financial institutions" include securities firms, insurance companies, fiduciaries (any legal entity that is authorized to manage assets on behalf of a third party, including pension funds) and beneficiaries (legal entities that receive or may become eligible to receive benefits under a will, insurance policy, retirement plan, annuity or trust).<sup>15</sup> For purposes of the U.S. LCR, "financial sector entity" means an investment adviser registered with the Securities and Exchange Commission (the "SEC") or a foreign equivalent; an investment

<sup>14</sup> Basel Committee NSFR ¶ 16.

<sup>15</sup> Basel Committee, *Basel III: The Liquidity Coverage Ratio and liquidity risk monitoring tools* (the "Basel LCR") (Jan. 2013), ¶¶ 109 n.43, 44; 131(e), available at <http://www.bis.org/publ/bcbs238.htm>. The Basel LCR also specifically refers to superannuation funds, mortgage funds and money market funds as financial institutions. Basel LCR ¶ 6(iv). In contrast, the Basel LCR excludes non-financial corporates, sovereigns, multilateral development banks and public sector entities from inclusion in the term financial institution. Basel LCR ¶ 154.



company registered with the SEC or a foreign equivalent; a pension fund;<sup>16</sup> a non-regulated fund;<sup>17</sup> a regulated financial company;<sup>18</sup> and certain companies designated by the Banking Agencies.<sup>19</sup> Both terms thus encompass an expansive array of market participants.

### III. AVAILABLE STABLE FUNDING (NUMERATOR)

#### A. Is ASF Made up of Assets, Liabilities, Capital or Some Combination?

ASF is composed of liabilities and capital instruments. As noted in II.C above, different categories of liabilities and capital are assigned different percentage factors, depending on broad characteristics of relative stability (e.g., funding tenor and counterparty), which are multiplied against the value of each instrument included in the relevant category before adding up total ASF.

#### B. What Are the Primary Categories of Liabilities and Capital That Make up ASF Generally?

The primary categories of liabilities and capital that make up ASF include borrowings of different maturity lengths and from different sources, various types of cash deposits, and certain capital instruments. Categories that are assigned a 0% factor and thus do not count towards a banking organization's ASF include liabilities without stated maturities (including short positions and open maturity positions), derivative liabilities and certain trade date payables. Refer to Table 1, appended to this update and reproduced from the NSFR, for a list of liabilities and capital that fall into each percentage bucket.

#### C. What Are Some Examples of Liabilities Relevant to Banks That Constitute ASF?

NSFR liabilities relevant to banks include (i) term deposits with residual maturities of one year or more (100% ASF), (ii) deposits with residual maturities of less than one year provided by retail and small business customers that are considered "stable" (defined in the U.S. LCR to mean fully covered by deposit insurance and held by the depositor in a transactional account or held by depositors who have other established relationships with the banking organization) (95% ASF), (iii) deposits that are less stable with residual maturities of less than one year and provided by retail and small business customers (90% ASF), and (iv) operational deposits (50% ASF).<sup>20</sup>

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<sup>16</sup> Pension funds include employee benefit plans as defined in ERISA, governmental plans "established or maintained for its employees by the Government of the United States, by the government of any State or political subdivision thereof, or by any agency or instrumentality of any of the foregoing," and foreign equivalents. U.S. LCR, 79 Fed. Reg. 61440, 61526 (Oct. 10, 2014); 29 U.S.C. § 1002(32).

<sup>17</sup> This refers to hedge funds or private equity funds whose investment advisors are required to file SEC Form PF, other than certain small business investment companies. *Id.*

<sup>18</sup> This refers to depository institution holding companies and certain of such entities' subsidiaries, depository institutions, foreign banks, credit unions, industrial loan companies, industrial banks, national banks, state member banks, state non-member banks that are not depository institutions, securities holding companies, brokers, dealers, futures commission merchants, swap dealers, security-based swap dealers, certain financial market utilities, and foreign entities regulated in a manner akin to the aforementioned entities. U.S. LCR, 79 Fed. Reg. 61527.

<sup>19</sup> U.S. LCR, 79 Fed. Reg. 61525.

<sup>20</sup> Operational deposits are defined in the U.S. LCR to mean unsecured wholesale funding or a collateralized deposit that is necessary for the banking organization to "provide operational services as an independent third-party intermediary, agent, or



**D. What Are Some Examples of Liabilities Relevant to Broker-Dealers That Constitute ASF?**

Broker-dealers also take deposits from customers in the form of free credit balances, and while those monies constitute ASF, they may receive unfavorable treatment because they are not bank deposits (0% ASF).<sup>21</sup> A subordinated loan pursuant to SEC Rule 15c3-1 that is treated as good capital also would constitute a liability for ASF purposes (ASF value depends on the remaining term). Other NSFR liabilities that may be relevant to broker-dealers include funding with residual maturity of less than one year provided by non-financial corporate customers (50% ASF), funding with residual maturity of less than one year provided by sovereigns, public sector entities (“PSEs”), and multilateral and national development banks (50% ASF), and funding with a maturity between six months to less than one year provided by central banks and financial institutions (50% ASF). Funding from short-term repurchase transactions with financial institutions generally has a 0% ASF value.

**E. Once I Have Categorized Appropriate Liabilities and Capital, How Do I Calculate ASF?**

To calculate ASF, a banking organization’s liabilities and capital are assigned one of five percentage multipliers based on their stability and reliability over longer time horizons. After multiplying the organization’s liabilities and capital by the relevant multiplier factors, the weighted amounts are added and the total is the banking organization’s ASF. For purposes of this calculation, the carrying value (the amount at which a liability or capital instrument is recorded before the application of regulatory deductions or other adjustments) of liabilities is utilized.

**F. What Are the ASF Factors (Percentages) for the Different Categories of ASF Liabilities and Capital?**

There are five ASF factors: 100%, 95%, 90%, 50% and 0%. Refer to Table 1, appended to this update and reproduced from the NSFR, for a list of the liability and capital categories in each percentage bucket.

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administrator to the wholesale customer or counterparty providing the unsecured wholesale funding or collateralized deposit.” U.S. LCR, 79 Fed. Reg. 61440, 61526. To qualify as an operational deposit, the following additional requirements must be met: (1) the related operational services must be performed pursuant to a binding written contract (i) whose termination is subject to a 30 calendar-day notice period or (ii) whose termination will result in significant termination or switching costs; (2) the deposit is held in an account designated as an operational account; (3) the customer holds the deposit for the primary purpose of obtaining the bank’s services; (4) the account is not designed to create an economic incentive for the customer to maintain excess funds; (5) the bank demonstrates that the deposit is empirically linked to the operational services and that it has a methodology taking into account the volatility of the average balance for identifying excess amounts that are excluded from the operational deposit amount; (6) the deposit is not provided in connection with the banking organization’s prime brokerage services; and (7) the deposit is not for arrangements in which the banking organization holds excess funds in an overnight deposit for another depository institution bank.

<sup>21</sup> Under the U.S. LCR, a deposit must meet the definition of section 3(1) of the Federal Deposit Insurance Act.

#### IV. REQUIRED STABLE FUNDING (DENOMINATOR)

##### A. Is RSF Composed of Assets, Liabilities, Capital or Some Combination?

RSF is composed of assets<sup>22</sup> and certain off-balance sheet exposures.<sup>23</sup>

##### B. What Are the Primary Categories of Assets That Make up RSF Generally?

The primary categories of assets that compose RSF include securities (residential mortgage-backed securities, corporate debt securities, securities representing claims on sovereigns and central banks, and equity securities not issued by financial institutions), loans (to financial institutions and to non-financial corporate clients, retail customers, sovereigns and PSEs), unencumbered residential mortgages, derivative assets, and deposits held at other financial institutions for operational purposes. Assets assigned a 0% RSF, which have the greatest liquidity, are of the greatest quality and/or have the shortest maturity, include coins, central bank reserves, and certain trade date receivables arising from the sale of financial instruments, foreign currencies and commodities. Refer to Table 2 and Table 3, appended to this update and reproduced from the NSFR, for a list of assets and off-balance sheet items that fall into each percentage bucket.

##### C. What Are Some Examples of Assets Relevant to Banks That Constitute RSF?

Assets relevant to a bank that constitute RSF include (1) loans made to different types of entities (financial institutions, central banks, non-financial corporate clients, retail customers, small business customers, sovereigns and PSEs) with varied residual maturities (less than six months, between six months to less than one year, and one year or more), with assorted designations under the Basel II standardized approach for credit risk, with factor designations also depending on whether the loans are encumbered, whether they are secured against assets that qualify under the U.S. LCR as Level 1 (including Treasuries, liquid and readily marketable U.S. agency securities guaranteed by the full faith and credit of the U.S., and certain claims on sovereigns) and whether they are performing (with RSF values ranging from 10% to 100%); and (2) certain unencumbered residential mortgages with a residual maturity of one year or more (65% RSF).

##### D. What Are Some Examples of Assets Relevant to Broker-Dealers That Constitute RSF?

Assets relevant to broker-dealers that constitute RSF include certain marketable securities of sovereigns (5% and 15% RSF); corporate debt securities of various ratings (15% and 50% RSF); residential mortgage-backed securities with at least an AA rating (50% RSF); exchange-traded (50% and 85% RSF) and non-exchange traded equity shares (100% RSF); cash, securities or other assets provided to the default fund of a central counterparty (such as the National Securities Clearing Corporation) (85% RSF); and unencumbered securities

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<sup>22</sup> The NSFR appears to apply to all assets of banking organizations. When the NSFR is adopted by the U.S. Regulators, the term may be further defined to identify what it includes and what it excludes.

<sup>23</sup> The Volcker Rule, as incorporated in section 619 of the Dodd-Frank Act, places limits on the proprietary trading activities of banking organizations. In addition to the required stable funding for a banking organization's outstanding exposures, a banking organization must ensure such exposures meet an applicable exception or exemption under the Volcker Rule. 12 U.S.C. § 1851.

with a remaining maturity of one year or more (85% RSF). Margin loans would be included in the types of loans included in RSF (10%, 15% and 50% RSF).

#### **E. Once I Have Categorized Appropriate Assets, How Do I calculate RSF?**

To calculate RSF, a banking organization's assets and certain off-balance sheet exposures are assigned one of eight percentage multipliers, based on the Basel Committee's judgment as to the amount of required stable funding needed to insulate the banking organization against potential future liquidity stress. The Basel Committee considered a number of criteria and assumptions in assigning RSF factors, including: (i) the importance of required stable funding for some portion of lending to the real economy; (ii) banking organizations may roll over a large proportion of maturing loans for relationship purposes; (iii) some assets maturing in less than one year require a small amount of less stable funding because banking institutions will allow a proportion of those assets to mature; and (iv) unencumbered, high-quality assets that can be securitized or traded do not need to be wholly financed with stable funding. After multiplying assets by the relevant multipliers, weighted amounts are added and the total is the banking organization's RSF.

#### **F. What Are the RSF Factors (Percentages) for the Different Categories of RSF Assets?**

There are eight RSF factors: 0%, 5%, 10%, 15%, 50%, 65%, 85% and 100%. Refer to Table 2, appended to this update and reproduced from the NSFR, for a list of asset categories in each percentage bucket.

### **V. EXAMPLES OF THE NSFR APPLIED TO TYPICAL BANK-AFFILIATED BROKER-DEALER ACTIVITIES**

#### **A. What Happens when a Broker-Dealer Tries to Fund Customer Margin Loans with Overnight Repo Financing?**

Margin loans extended to financial institutions typically would be assigned a 15% RSF while all other margin loans, including to retail and non-financial corporate clients, would be assigned a 50% RSF. A broker-dealer would be able to fund either of these activities with repo financing provided by non-financial corporate customers, which is assigned a 50% ASF. However, in the more likely event that the broker-dealer sought to rely on repo financing provided by a financial institution counterparty, such financing is assigned a 0% ASF and the broker-dealer would need another source of ASF to balance out the ratio.

For example, if a bank-affiliated broker-dealer lends \$100 to a client, it will incur \$15 of RSF if the client is a financial institution and \$50 of RSF if the client is a non-financial corporate client. On the other hand, repo financing provided by a financial institution counterparty would not provide the broker-dealer with a source of ASF. As a result, the broker-dealer will have to locate either \$15 or \$50 of ASF, respectively, to counterbalance the RSF charge.

**B. How About Trying to Fund Margin Loans with Brokerage Account Free Credit Balances?**

As noted above, margin loans extended to financial institutions would typically be assigned a 15% RSF while all other margin loans, including to retail and non-financial corporate clients, would be assigned a 50% RSF. A broker-dealer would not be able to fund these margin loans with brokerage account free credit balances, whether provided by retail, non-financial corporate or financial (e.g., prime brokerage) customers, as such funding seems to carry a 0% ASF factor. Please note that consistent with the U.S. LCR, retail customers' free credit balances do not qualify as demand or term deposits, because free credit balances are not bank deposits, and thus do not qualify for the 90% or 95% ASF afforded such deposits.<sup>24</sup>

**C. What Is the Treatment of Positions Held Overnight as a Result of Market-Making Activities?**

Securities and other non-cash assets held overnight must be funded, with RSF factors ranging from 5% to 50%, depending on the quality of the securities. See Tables 2 and 3 appended to this update for the RSF factors for the various types of assets.

**D. How Are the Securities Borrowed by a Broker-Dealer to Satisfy Customer Short Sales Treated?**

Securities borrowed by a broker-dealer to satisfy customer short sales are considered encumbered securities. To the extent they are held on the broker-dealer's balance sheet, such securities must be funded and are assigned a 50% RSF factor. See Section V.F below for a discussion of the treatment of typical securities lending transactions.

**E. How Does the NSFR Treat Deposits and Margin Posted at Central Counterparties?**

Cash, securities and other assets posted as margin on derivatives or to a CCP default fund must be funded and are assigned an 85% RSF factor.

**F. What Is the Treatment of Securities Lending Transactions under the NSFR?**

In a typical securities lending transaction, a broker-dealer borrows securities from a lender (typically through an agent bank intermediary) and lends the securities to its borrower client. At the same time, the broker-dealer takes collateral from its borrower client and posts this collateral to the lender (also generally via an agent bank intermediary). If the collateral received from the borrower client and posted to the lender is cash, then, prior to unwinding the securities loan, the broker-dealer will hold both a cash receivable (from the lender) and a cash payable (to the borrower) on its balance sheet. The cash receivable would generally incur a 15% RSF factor if the lender is a financial institution and a 50% RSF factor if the lender is a non-financial corporate client. The cash payable, on the other hand, would receive a 0% ASF factor if the borrower is a financial institution and a 50% ASF factor in the unlikely event the borrower is a non-financial corporate client. As a result, securities lending involving a financial institution borrower may need to be funded by

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<sup>24</sup> Also consistent with the LCR, U.S. Regulators may wish to adopt more favorable treatment for such funding, to the extent provided by retail, as opposed to corporate, customers.

other activities at the banking organization, because there will be an RSF charge that is not counterbalanced with ASF from the back-to-back transaction. On the other hand, securities lending involving a non-financial corporate borrower may be a source of funding for the banking organization; ASF will outweigh RSF when the lender is a financial organization and will be equivalent to RSF when the lender is a non-financial corporate entity. The treatment of back-to-back repo and reverse repo transactions would be the same.

## **VI. EXAMPLES OF THE NSFR APPLIED TO TYPICAL BANKING ACTIVITIES**

### **A. What Happens When a Bank Tries to Fund Residential Mortgages with Repo Financing?**

Residential mortgages with a residual maturity of one year or more must be funded. Depending on the risk weighting under the Basel III standardized approach, these mortgages may be assigned a 65% or 85% RSF factor. A banking organization would be able to partially fund these mortgages with repo financing provided by non-financial corporate customers, which is assigned a 50% ASF factor, but would not be able to rely on repo financing provided by financial counterparties, which is assigned a 0% ASF factor.

For example, if a banking organization lends \$100 to a residential mortgagor, it will incur either \$65 or \$85 of RSF (depending on the risk weighting of the mortgage under the Basel III standardized approach). If the bank funds its \$100 loan with \$100 of repo financing provided by non-financial corporate customers, it will have \$50 of ASF to partially offset its RSF charge. On the other hand, the banking organization will have no ASF to counterbalance its RSF charge if it funds the loan with repo financing provided by financial counterparties.

### **B. How About Trying to Fund Residential Mortgages with Retail Deposits?**

As noted above, residential mortgages with a residual maturity of one year or more will be assigned a 65% or 85% RSF factor. A banking organization would be able to rely on retail deposits to fund such mortgages because retail deposits are assigned a 90% or 95% ASF factor.

### **C. What Is the NSFR Treatment of Conduit Securities Lending Transactions?**

Conduit lending involves a bank acting as a riskless principal intermediary between a lender and the borrower. Much like the scenario discussed in section V.F. above, the bank borrows securities from the lender client and lends the securities to the borrower client. At the same time, the bank takes collateral from the borrower client and posts collateral to the lender client. If the collateral received from the borrower client and posted to the lender client is cash, then, prior to unwinding the conduit loan, the bank will hold both a cash receivable (from the lender) and a cash payable (to the borrower) on its balance sheet. The cash receivable would generally receive a 15% RSF factor if the lender is a financial institution and a 50% RSF factor if the lender is a non-financial corporate client. The cash payable, on the other hand, would receive a 0% ASF factor if the borrower is a financial institution and a 50% ASF factor if the borrower is a non-financial corporate client. As a result, conduit lending involving a financial institution borrower may need to be funded by other activities at the banking organization because, whether the lender is a financial institution or a non-financial

corporate client, there will be an RSF charge that is not counterbalanced by ASF. On the other hand, conduit lending involving a non-financial corporate client borrower may be a source of funding for the banking organization, because ASF will outweigh RSF when the lender is a financial organization and will hold steady with RSF when the lender is a non-financial corporate entity.

**D. How Does the NSFR Treat Interdependent Assets and Liabilities? Does This Include Matched Book Securities Financing/Lending Transactions?**

The NSFR provides individual jurisdictions discretion to set ASF and RSF factors to zero in the case of interdependent assets and liabilities.<sup>25</sup> The exception, if incorporated into the U.S. NSFR, applies when certain assets and liabilities are interdependent such that the liability cannot come due while the asset remains on the banking enterprise's balance sheet, the principal payment flows from the asset cannot be used for anything other than repaying the liability, and the liability cannot be used to fund other assets.<sup>26</sup> The NSFR provides additional requirements that must be met: the individual asset and liability must be clearly identifiable; the maturity and principal amount of the liability and asset must be identical; the bank is acting only as a pass-through unit to channel the funding received into the asset; and the counterparties for each pair of liabilities and assets are different.<sup>27</sup>

This exception may apply in the case of matched book securities financing transactions. Matched book repos and reverse repos occur when a banking organization: (1) purchases securities, thus receiving securities and providing payment to the securities owner, pursuant to an agreement that the seller will buy back the securities, and also (2) sells the same securities, thereby providing the securities and receiving cash in exchange, with an agreement to buy back the securities. Depending on whether and how it is incorporated into the U.S. NSFR, the interdependent liability exception may apply to this scenario, because the liability (payment owed by the banking organization to repurchase the securities from the securities buyer) and the asset (the funds paid to the seller of securities) are clearly identifiable; the maturity and principal amount of both the repo and the reverse repo are identical; the banking organization is acting as a pass-through entity to channel the funding received into the corresponding asset; and the counterparties for each pair of liabilities and assets are different. Furthermore, the liability cannot fall due while the asset remains on the balance sheet, because the reverse repo and the repo are generally unwound simultaneously (and thus the banking organization's payment of cash to the securities borrower occurs when it has received cash from the securities seller to repurchase the securities); the funds received by the banking organization from repayment by the securities seller are typically used to pay for the repurchase of the securities; and the banking organization would not have purchased the securities in the first place if it did not have a willing purchaser of such securities, thus ensuring that the liability (cash eventually owed to the securities purchaser) would not have been entered into but for the asset (the cash ultimately to be received by the banking organization from the securities seller). If this treatment were confirmed as part of the U.S. NSFR, it also could apply to conduit securities lending, which involves similar back-to-back transactions. At this stage it is uncertain whether U.S. regulators will incorporate some version of the Basel Committee's interdependent assets and liabilities

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<sup>25</sup> Basel Committee NSFR ¶ 45.

<sup>26</sup> *Id.*

<sup>27</sup> *Id.*



provision into the U.S. NSFR, or what the scope of any such provisions might include. Some of Governor Tarullo's remarks, including as discussed in Section I.D above, highlight that uncertainty.

#### **VII. WHAT IS THE NSFR TREATMENT OF HIGH-QUALITY LIQUID ASSETS HELD TO MEET LCR REQUIREMENTS?**

High-quality liquid assets (“HQLA”) held to meet LCR requirements<sup>28</sup> are assigned RSF factors ranging from 0% to 50%. HQLA consisting of central bank reserves is assigned a 0% RSF factor. A 5% RSF factor is applied to unencumbered Level 1 HQLA, including certain marketable securities issued or guaranteed by sovereigns. When a loan is secured by Level 1 HQLA, the loan receives a 10% factor. Unencumbered Level 2A HQLA is assigned a 15% factor, while unencumbered Level 2B HQLA is assigned a 50% factor. HQLA held to meet LCR requirements is assigned a 50% RSF factor when it is encumbered for a period of between six months to less than one year and if it is not otherwise assigned an RSF factor and has a residual maturity of less than one year.

#### **VIII. DOES THE NSFR FAVOR THE ISSUANCE OF CERTAIN TYPES OF SECURITIES BY BANKING ORGANIZATIONS FOR FUNDING PURPOSES?**

The NSFR favors the issuance of capital instruments with residual maturities of one year or more, which are assigned a 100% ASF factor so long as such instruments do not allow for early maturation.<sup>29</sup> The issuance of commercial paper by a banking organization would receive a less favorable 50% ASF factor.

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Please do not hesitate to contact us with any questions.

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<sup>28</sup> HQLA and other assets held for liquidity management purposes qualifies for the “liquidity management” exception from the definition of “proprietary trading” under § 3(d)(3) of the Volcker Rule. Additionally, certain assets, such as Treasuries and U.S. agency securities, are granted an explicit exemption from the proprietary trading prohibitions.

<sup>29</sup> One example might be ten-year bonds issued by the bank holding company.

| Summary of liability categories and associated ASF factors |  | Table 1 |
|--|--|---------|
| ASF factor   | Components of ASF category   |         |
| 100%   | <ul style="list-style-type: none"> <li>Total regulatory capital (excluding Tier 2 instruments with residual maturity of less than one year)</li> <li>Other capital instruments and liabilities with effective residual maturity of one year or more</li> </ul>   |         |
| 95%  | <ul style="list-style-type: none"> <li>Stable non-maturity (demand) deposits and term deposits with residual maturity of less than one year provided by retail and small business customers</li> </ul>   |         |
| 90%  | <ul style="list-style-type: none"> <li>Less stable non-maturity deposits and term deposits with residual maturity of less than one year provided by retail and small business customers</li> </ul>   |         |
| 50%  | <ul style="list-style-type: none"> <li>Funding with residual maturity of less than one year provided by non-financial corporate customers</li> <li>Operational deposits</li> <li>Funding with residual maturity of less than one year from sovereigns, PSEs, and multilateral and national development banks</li> <li>Other funding with residual maturity between six months and less than one year not included in the above categories, including funding provided by central banks and financial institutions</li> </ul> |         |
| 0%   | <ul style="list-style-type: none"> <li>All other liabilities and equity not included in the above categories, including liabilities without a stated maturity (with a specific treatment for deferred tax liabilities and minority interests)</li> <li>NSFR derivative liabilities net of NSFR derivative assets if NSFR derivative liabilities are greater than NSFR derivative assets</li> <li>“Trade date” payables arising from purchases of financial instruments, foreign currencies and commodities</li> </ul>        |         |

| Summary of asset categories and associated RSF factors |   | Table 2 |
|--|---|---------|
| RSF factor   | Components of RSF category  |         |
| 0%   | <ul style="list-style-type: none"> <li>• Coins and banknotes</li> <li>• All central bank reserves</li> <li>• All claims on central banks with residual maturities of less than six months</li> <li>• “Trade date” receivables arising from sales of financial instruments, foreign currencies and commodities.</li> </ul>   |         |
| 5%   | <ul style="list-style-type: none"> <li>• Unencumbered Level 1 assets, excluding coins, banknotes and central bank reserves</li> </ul>   |         |
| 10%  | <ul style="list-style-type: none"> <li>• Unencumbered loans to financial institutions with residual maturities of less than six months, where the loan is secured against Level 1 assets as defined in LCR paragraph 50, and where the bank has the ability to freely rehypothecate the received collateral for the life of the loan</li> </ul>   |         |
| 15%  | <ul style="list-style-type: none"> <li>• All other unencumbered loans to financial institutions with residual maturities of less than six months not included in the above categories</li> <li>• Unencumbered Level 2A assets</li> </ul>  |         |
| 50%  | <ul style="list-style-type: none"> <li>• Unencumbered Level 2B assets</li> <li>• HQLA encumbered for a period of six months or more and less than one year</li> <li>• Loans to financial institutions and central banks with residual maturities between six months and less than one year</li> <li>• Deposits held at other financial institutions for operational purposes</li> <li>• All other assets not included in the above categories with residual maturity of less than one year, including loans to non-financial corporate clients, loans to retail and small business customers, and loans to sovereigns and PSEs</li> </ul> |         |
| 65%  | <ul style="list-style-type: none"> <li>• Unencumbered residential mortgages 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</li> <li>• 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</li> </ul>   |         |
| 85%  | <ul style="list-style-type: none"> <li>• Cash, securities or other assets posted as initial margin for derivative contracts and cash or other assets provided to contribute to the default fund of a CCP</li> <li>• Other unencumbered performing loans with risk weights greater than 35% under the standardised approach and residual maturities of one year or more, excluding</li> </ul>  |         |

| Summary of asset categories and associated RSF factors |   | Table 2 |
|--|---|---------|
| RSF factor   | Components of RSF category  |         |
|  | loans to financial institutions <ul style="list-style-type: none"> <li>• Unencumbered securities that are not in default and do not qualify as HQLA with a remaining maturity of one year or more and exchange-traded equities</li> <li>• Physical traded commodities, including gold</li> </ul>  |         |
| 100%   | <ul style="list-style-type: none"> <li>• All assets that are encumbered for a period of one year or more</li> <li>• NSFR derivative assets net of NSFR derivative liabilities if NSFR derivative assets are greater than NSFR derivative liabilities</li> <li>• 20% of derivative liabilities as calculated according to paragraph 19</li> <li>• 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, items deducted from regulatory capital, retained interest, insurance assets, subsidiary interests and defaulted securities</li> </ul> |         |

| Summary of off-balance sheet categories and associated RSF factors                     |   | Table 3 |
|--|---|---------|
| RSF factor   | RSF category  |         |
| 5% of the currently undrawn portion  | Irrevocable and conditionally revocable credit and liquidity facilities to any client   |         |
| National supervisors can specify the RSF factors based on their national circumstances | <p>Other contingent funding obligations, including products and instruments such as:</p> <ul style="list-style-type: none"> <li>• Unconditionally revocable credit and liquidity facilities</li> <li>• Trade finance-related obligations (including guarantees and letters of credit)</li> <li>• Guarantees and letters of credit unrelated to trade finance obligations</li> <li>• Non-contractual obligations such as: <ul style="list-style-type: none"> <li>– potential requests for debt repurchases of the bank’s own debt or that of related conduits, securities investment vehicles and other such financing facilities</li> <li>– structured products where customers anticipate ready marketability, such as adjustable rate notes and variable rate demand notes (VRDNs)</li> <li>– managed funds that are marketed with the objective of maintaining a stable value</li> </ul> </li> </ul> |         |