Statement by Martin J. Gruenberg, Member, FDIC Board of Directors on the Final Rule: Net Stable Funding Ratio

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Introduction

In April 2016, the FDIC Board adopted a Notice of Proposed Rulemaking (NPR) to implement a net stable funding ratio (NSFR) requirement for large banking organizations pursuant to a Basel Committee Agreement.[1]

Today, the FDIC Board is considering a Final Rule to implement the NSFR. As compared to the Notice of Proposed Rulemaking, this Final Rule would severely reduce the number of large banking organizations subject to the NSFR, it would significantly weaken the substantive requirements of the NSFR in ways that would not be compliant with the Basel Agreement, and it would provide for less timely public disclosure of the NSFR. For these reasons, I will vote against this Final Rule.

Background

One of the critical vulnerabilities identified in the financial crisis of 2008 was liquidity risk, in particular overreliance on less-stable, short-term funding. As the preamble to the NPR pointed out:

"During the crisis, many banking organizations experienced severe contractions in the supply of funding. As access to funding became limited and asset prices fell, many banking organizations faced the possibility of default and failure. The threat this presented to the 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 to address these shortcomings at banking organizations and to implement a more rigorous approach to identifying, measuring, monitoring, and limiting reliance by banking organizations on less stable sources of funding."[2]

The Basel Committee on Banking Supervision, as part of its post-crisis reforms, developed a new international framework for liquidity risk management for large banking organizations which addressed the risk of reliance on short-term funding in two complementary ways.

First, the framework established a liquidity coverage ratio (LCR) to ensure that large banking organizations had sufficient high quality liquid assets that could be readily converted into cash to meet net cash outflows over a 30 calendar-day stress period.[3]

Second, the framework established a net stable funding ratio, which complements the LCR by ensuring that large banking organizations avoid excessively funding long-term, less-liquid assets with short-term, less-stable funding. It requires large banking organizations to have sufficient amounts of stable funding to support assets, derivative exposures, and credit and liquidity commitments over a one-year time frame.[4]

In 2014, the federal banking agencies finalized a rule to implement the liquidity coverage ratio in the United States.[5] As mentioned, in 2016 the federal banking agencies approved a Notice of Proposed Rulemaking to implement a net stable funding ratio, and today the FDIC is considering a Final Rule to implement the NSFR.

Narrowing the Scope of Institutions Subject to the NSFR

The first point to make about the Final Rule is that it would severely narrow the scope of banking organizations subject to an NSFR requirement as compared to the NPR.

If the NSFR standard of the NPR were applied as of the second quarter 2020, 21 banking organizations in the United States would be subject to the full NSFR. An additional 14 banking organizations would be subject to a 70 percent NSFR requirement. In total, 35 banking organizations in the United States would be subject to an NSFR requirement under the NPR.[6] [7]

The Final Rule before the FDIC Board today would apply the full NSFR to nine banking organizations - the eight U.S. Global Systemically Important Banks (G-SIBs) and a smaller banking organization with greater than $75 billion in cross-jurisdictional activity.[8]

In addition, the Final Rule would apply a reduced 85 percent NSFR requirement to 11 banking organizations with greater than $100 billion in assets and less than $75 billion in average weighted short-term wholesale funding. A total of 20 banking organizations would be subject to an NSFR requirement under the Final Rule.[9] An additional 15 banking organizations with over$100 billion in assets that would have been subject to a full or 70 percent standard under the NPR would not be subject to any requirement under the Final Rule.

While the Global Systemically Important Banks pose the greatest risk to financial stability, large regional banks in the United States, individually and collectively, also may pose significant financial stability risks. Subjecting them to a reduced or no NSFR requirement, as this Final Rule would do, seriously undermines the purpose of the Rule.

Weakening NSFR Requirements for Level 1 Liquid Asset Securities[10] and Reverse Repos in Violation of the Basel Agreement

Second, in addition to severely narrowing the number of large banking organizations subject to the NSFR, the Final Rule also makes two important changes that significantly weaken the substantive requirements of the NSFR and that are not in compliance with the Basel Agreement.

The NPR and the Final Rule would require a banking organization to maintain an amount of available stable funding (ASF) equal to or greater than the banking organization's projected minimum funding needs, or required stable funding (RSF), over a one-year time frame.

The NPR assigned a 5 percent required stable funding factor to unencumbered level 1 liquid asset securities, which include U.S. Treasury securities and U.S. government agency securities, many of which are financed through the repo market.[12] The NPR assigned a 10 percent required stable funding factor to short-term secured lending transactions backed by level 1 liquid asset securities, which would include reverse repo transactions.[13] Both of these requirements were consistent with the Basel NSFR standard.[14]

The Final Rule would assign a zero percent required stable funding factor to both level 1 liquid asset securities and short-term lending transactions backed by them, which would not be incompliance with the Basel standard, as acknowledged in the preamble to the Final Rule.[15] The consequence of these changes removes all requirements for a large banking organization subject to the NSFR to maintain available stable funding support for Level 1 liquid asset securities, which, as noted previously, rely on the repo market for a steady source of financing, and reverse repo transactions. Full reliance would be placed on the Federal Reserve to support the U.S. Treasury and repo markets under stress.

The preamble to the Final Rule lays out the arguments both for and against these changes.

In support of the changes, the preamble states:

"Although U.S. Treasury securities and other level 1 liquid asset securities generally must be monetized before they can be used to settle obligations and face modest transaction costs in doing so, these assets, regardless of their contractual maturity, serve as reliable sources of liquidity across market conditions, based on their high credit quality and the favorable characteristics of the markets for these assets. Further, level 1 liquid asset securities generally retain their value in the event of market disruptions relative to most other assets. In addition, these level 1 liquid asset securities serve a critically important role in supporting the smooth functioning of the funding markets, and… a non-zero RSF factor on level 1 liquid assets could discourage intermediation in the U.S. Treasury market. For these reasons, the final rule applies a zero percent RSF factor to unencumbered level 1 liquid assets."[16]

The preamble also presents the arguments in favor of the NPR proposals:

"The agencies identified two benefits of a small RSF requirement on level 1 liquid assets. The first benefit is that the stable funding requirement would help insulate covered companies against sharp price declines of level 1 liquid assets…. A small RSF requirement on level 1 liquid assets would ensure that covered companies fund a small portion of these securities from stable sources, which could ease the liquidity pressure caused by price declines and thus potentially reduce the need for Federal Reserve liquidity support in times of stress.

The second benefit of a small RSF requirement is that it would insulate covered companies against the systemic risk associated with the interconnectedness of short-term financing positions secured by level 1 liquid assets…. A small RSF requirement would incentivize covered companies to fund level 1 liquid assets with more stable funding, which would reduce the risks associated with interconnected short-term financing positions."[17]

The preamble weighs the arguments in favor and against the NPR requirements and reaches the following conclusion:

"After considering the above costs and benefits, importantly including the concern that a small RSF requirement could interfere with the functioning of U.S. Treasury and repo markets by disincentivizing covered companies from acting as intermediaries, the agencies are adopting as part of the final rule a zero percent RSF factor for level 1 liquid assets held as securities and for short-term secured lending transactions secured by level 1 liquid assets."[18]

The better approach was taken in the NPR, which would have imposed a modest but important stable funding obligation on these activities, which have proven, by experience, to be subject to volatility. Otherwise these large banking organizations are freed from any obligation to take responsibility for the liquidity risks of these activities. The entire risk is effectively transferred to the public sector through the Federal Reserve. That defeats the purpose of the net stable funding ratio requirement.

Weakening NSFR Requirements for Uninsured Affiliate Sweep Deposits

Third, the most significant change made by the Final Rule to weaken the available stable funding standard of the NPR is to increase from 50 percent to 90 percent the ASF factor for affiliate sweep deposits where less than the entire amount of the deposit is covered by deposit insurance.[19] The ASF factor for the most stable funding is 100 percent.

The preamble to the Final Rule seems to base this change on the following point:

"The final rule takes into account that the priority relationship with an affiliate results in a deposit relationship that is reflective of an overall relationship with the underlying retail customer where these deposits generally exhibit a stability profile associated with deposits directly from retail customers, even if the deposits are not fully covered by deposit insurance."[20]

The preamble to the Final Rule provides no analysis to support this assertion. It is equally plausible that when a banking organization faces market stress, sweeps customers may reduce their exposure to ensure deposit insurance coverage or exit the relationship entirely despite potential contractual costs.

This assertion also is at odds with the point made in the preamble that affiliate relationships maybe no more stable than relationships with non-affiliated companies:

"…as a general matter, an affiliate would not necessarily improve the funding stability of the covered company. Banking organizations that generally rely on funding from financial sector affiliates may have similar balance sheet funding risks to those that generally rely on funding of the same tenor from non-affiliates."[21]

Absent full deposit insurance coverage, the 50 percent available stable funding factor provided by the NPR is far more appropriate than the 90 percent factor of the Final Rule and would not weaken the NSFR requirement for banking organizations that have these sweep arrangements.

Weakening Public Disclosure Requirements

Finally, both the NPR and the Final Rule provide significant public disclosure requirements for banking organizations subject to the NSFR.[22]

Quantitative disclosure requirements would apply to the banking organization's NSFR and its available stable funding and required stable funding components. In addition, the banking organization would be required to provide a qualitative discussion of the NSFR and its components sufficient to facilitate an understanding of the calculations and the results. The NPR provided for timely public disclosures after each calendar quarter. The first reporting period for which a banking organization would be required to disclose the company's NSFR and its components would be the calendar quarter that begins on the date the company becomes subject to the NSFR requirement. However, the Final Rule only provides for semi-annual public disclosure of two quarters, and the first reporting period for which the banking organization would be required to disclose the NSFR would be 18 months after the banking organization becomes subject to the NSFR requirement.[23]

As a result, the Final Rule provides much less timely public disclosure of the NSFR, undercutting a key objective of the standard.

Conclusion

In conclusion, as compared to the NPR, this Final Rule severely narrows the scope of banking organizations subject to the NSFR, significantly weakens the substantive requirements contrary to the Basel Agreement, and provides for less timely public disclosure. Taken together with weakening changes to the liquidity coverage ratio as a result of a rulemaking in 2019,[24] this reflects a substantial undermining of the entire post-financial crisis liquidity framework.

For these reasons, I will vote against this Final Rule.

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[1]Net Stable Funding Ratio: Liquidity Risk Measurement Standards and Disclosure Requirements, 81 FR 35124 (June 1, 2016).

[2]Id. at 35126, citing Senior Supervisors Group, Risk Management Lessons from the Global Banking Crisis of 2008 (Oct. 21, 2009), available at https://www.newyorkfed.org/medialibrary/media/newsevents/news/banking/2009/SSG_report.pdf.

[3]Basel III: The Liquidity Coverage Ratio and liquidity risk monitoring tools, available at https://bis.org/publ/bcbs238.pdf (Jan. 2013).

[4]Basel III: the net stable funding ratio (Oct. 2014), found at https://www.bis.org/bcs/publ/d295.htm, subsequently amended for national discretion for

NSFR's treatment of derivative liabilities (Oct. 2017), available at https://bis.org/press/p171006.htm.

[5]Final Rule: Liquidity Coverage Ratio: Liquidity Risk Measurement Standards, 79 FR 61440 (Oct.10, 2014).

[6]As a result of the Economic Growth, Regulatory Relief, and Consumer Protection Act, P.L. 115-174 (May 24, 2018), nine banks with assets between $50 and $100 billion were subsequently excluded. If the effects of that legislation were not taken into account, 23 banks would have been subject to the 70 percent NSFR, and a total of 44 banks would have been subject to an NSFR requirement.

[7]Data sources: FR Y-9C, FR Y-15, FR Y-9LP (4Q 2015 & 2Q 2020), and https://www.federalreserve.gov/aboutthefed/boardmeetings/files/tailoring-rule-visual-20191010.pdf.

[8]The eight U.S. G-SIBs are Bank of America, Bank of New York Mellon, Citigroup, Goldman Sachs, JP Morgan Chase, Morgan Stanley, State Street, and Wells Fargo, and the ninth bank referenced is Northern Trust. See https://www.federalreserve.gov/aboutthefed/boardmeetings/files/tailoring-rule-visual-20191010.pdf.

[9]Preamble to the NSFR Final Rule at 279.

[10]"Level 1 liquid asset" is defined at 12 CFR 329.20 and includes, for example, U.S. Treasury securities, securities issued or fully guaranteed by another U.S. government agency backed by full faith and credit and that is still liquid and readily marketable, and certain sovereign securities, as well as Federal Reserve Bank balances and foreign withdrawable reserves.

[11]A banking organization's available stable funding is a function of banking organization's liabilities and regulatory capital. A banking organization's required stable funding is a function of the liquidity characteristics of its assets, derivative exposures, and credit and liquidity commitments. Preamble to the NSFR Final Rule at 14-15, 22, 27, 32-33.

[12]Preamble to the NSFR NPR, 81 FR at 35142.

[13]Id. at 35143.

[14]Id. at 35127.

[15]Preamble to the NSFR Final Rule at 122 fn. 132, 132, and 134.

[16]Preamble to the NSFR Final Rule at 141-142.

[17]Id at 284-285.

[18]Id. at 285.

[19]Preamble to the NSFR Final Rule at 103, fn. 115.

[20]Id. at 104.

[21]Id. at 89.

[22]Id. at 265-274.

[23]Id. at 274-276.

[24]Final Rule: Changes to Applicability Thresholds for Regulatory Capital and Liquidity Requirements, 84 FR 59230 (Nov. 1, 2019).