Net Stable Funding Ratio (NSFR)

NSFR Continues the Trend of Funneling Liquidity to Sovereign Debt

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Executive Summary

- **The NSFR Proposal:** Basel III is an internationally agreed upon set of standards intended to strengthen the regulation, risk management, and supervision of the banking sector. It includes a mandate for the Net Stable Funding Ratio (NSFR), one of two new liquidity ratios. The NSFR requires banks with $250+ billion in assets to maintain a stable, one-to-one ratio or better of "available stable funding" relative to the composition of their assets and off-balance sheet activities. Such funding must have a maturity of one year or more, and include some deposits and equity. The NSFR generally is intended to shift liability maturities past the one-year threshold.

- **The NSFR is the second of two ratios required by the BCBS, and was preceded by the Liquidity Coverage Ratio (**LCR), which is intended to reinforce the short-term liquidity health of larger institutions. It requires banks to maintain an adequate supply of unencumbered 'high quality liquid assets' (HQLAs) that can be converted into cash easily and immediately to meet its liquidity needs for a 30-day stress period. Pursuant to Basel III, the LCR requirement was phased in by the U.S. starting in January 2015 and took full effect in January 2017.

NSFR QUICK FACTS

- Despite historically strong performance, highly rated CMBS are not counted as HQLAs, unlike other asset classes, such as corporates, which are treated preferentially.
- Zero percent of CMBS triple-A and junior triple-As (AM and AS classes) issued since 2005 have defaulted.
- Treasury's report series, *A Financial System that Creates Economic Opportunities*, calls out the LCR several times as a flawed rule, and the NSFR only builds on those flaws and potentially exacerbates problems for CMBS liquidity.

- **CMBS Doesn't Make the Cut for Preferential Treatment**: HQLA assets are divided into three levels: 1, 2A, and 2B, with increasing market-value haircuts applied to the HQLA assets based on the level. While IG-rated corporate debt securities are deemed to be Level 2B (25% to 50% haircuts), triple-A rated CMBS do not qualify as HQLAs.

- **What products the NSFR covers:** The rule will apply to CMBS, CRE CLOs, CMBX and to all commercial and multifamily real estate whole loans with maturities of more than one year.

- **Impact of the rule:** The proposed rule has not yet been finalized by U.S. regulators, but certain banks believe that the NSFR could be one of the more onerous capital and liquidity frameworks applied to date. The NSFR rule will reduce large banks' capacity for leverage even more than is currently available, particularly within their broker-dealer activities. This means that markets overall could suffer from some further contraction in liquidity. Within the securities markets and because of the NSFR's proposed risk weighting categories, the NSFR rule will tip lending costs even more to favor commercial and industrial financing and disadvantage commercial mortgage-backed securities (CMBS).

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CREFC Resources

- *CREFC Fact Sheet on Liquidity Coverage Ratio*
- *Joint Trade Associations Letter to the US Banking Agencies regarding the Net Stable Funding Ratio, 08.08.2016*
- *Industry letter to the US Banking Agencies regarding Liquidity Risk Management, 12.28.2016*
- *Industry Letter to the US Banking Agencies regarding the Liquidity Coverage Ratio, 03.13.2014*

For further Information, visit CREFC's Resource Center at: https://www.crefc.org/library

Potential Solutions

- **Bring CMBS Treatment into Alignment with Other Asset Classes:** U.S. CMBS market participants generally believe the LCR and NSFR rules should be recalibrated for CMBS in order to better align treatment of the sector with other similar asset classes and to converge with BCBS standards.

  - The underlying NSFR methodology incorporates the HQLA concept from the LCR rule and buckets asset classes based on perceived risk/stability.

  - Under U.S. liquidity rules requirements, corporate bonds are bucketed as Level 2B and Ginnie Mae Project Loans are bucketed as Level 1. No private-label CMBS or Single Asset Single Borrower (SASB) securities are considered HQLA. CREFC believes that triple-A rated super-senior CMBS and/or SASB should also be considered as Level 2B HQLAs.

  - BCBS standards allow broad interpretation when applying the HQLA standards within a jurisdiction, and the European Central Bank promulgated rules allowing private-label residential mortgage-backed bonds to be treated as HQLAs.

  - Furthermore, the BCBS adopted a "Simple, Transparent, Comparable" framework under which high-performing securitization bonds would be allowed safe harbors under capital and liquidity rules. U.S. regulators did not follow through on this work stream, despite the fact that the Europeans have adopted such a regime.

CREFC Policy & Strategy

- ***Recommendation:*** CREFC members generally agree that the regulators should consider HQLA status for highly-rated private-label CMBS.
- **Support for this recommendation:** CREFC members broadly support any measure that enhances CMBS liquidity.

Additional Background & History

- **History of Liquidity Requirements:** Basel III reforms are a direct response to the financial crisis requiring substantial increases in bank capital adequacy and apply first-ever liquidity requirements. These new standards were developed by the Basel Committee on Banking Supervision (BCBS), a committee that derives its authority from the G20 and is made up of regulatory leaders from that body. All BCBS standards must be implemented and enforced through national legislation and/or regulation (though some tailoring is allowed), as the BCBS has no legal authority over its members. The group monitors member countries' implementation and enforcement records to build and enforce its agenda.

- **Need for Liquidity Requirements:** Liquidity requirements are meant to complement capital requirements as a means to incent good judgment in bank balance sheet management. The two BCBS liquidity requirements, the Liquidity Coverage Ratio (LCR) and the Net Stable Funding Ratio (NSFR), were mandated for the first time under the Basel III regime promulgated in the wake of the crisis.
    - The LCR addresses short-term balance sheet liquidity (both asset and funding), seeking to ensure that a firm has enough liquid assets to cover short-term funding obligations given a scenario in which the bank is shut out of debt markets.
    - The framing principle behind the NSFR is to ensure that the bank carries enough long-term debt to cover the risks held on the asset side of the balance sheet.

- **Questionable Need for the Rule:** The NSFR is redundant in many ways, as the leverage ratio and risk-based capital rules also capture repo and other short-term funding and apply relatively higher costs to traded products, particularly securitized products. In his outgoing speech in April 2017, former Federal Reserve Governor, Daniel Tarullo, noted that the regulators had made substantial progress in reducing short-term leverage in the system, prior to the adoption of the NSFR rule. This can be seen in the securitization sector, as most asset classes with short-term funding (e.g., ABCP conduits) are now held and on balance sheet, and so are fully capitalized already. Since then, other regulatory officials have also cited the improvement in the banking industry's liability duration.