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Client Alert

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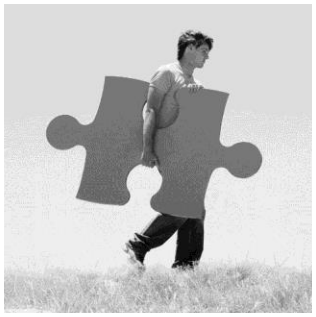

Is the End in Sight? FDIC Proposes the Net Stable Funding Ratio (“NSFR”): *Liquidity Risk Measurement Standards and Disclosure Requirements*

On April 26, 2016, the Federal Deposit Insurance Corporation (the “FDIC”) proposed a rule (the “Proposed Rule”) that would implement a quantitative long-term liquidity requirement—the net stable funding ratio (“NSFR”)—for large and internationally active banking organizations. The Office of the Comptroller of the Currency (the “OCC”) and the Board of Governors of the Federal Reserve System (“the Federal Reserve”) are expected to propose substantially identical versions of the Proposed Rule shortly. The Proposed Rule would be effective January 1, 2018. Comments are due to the Agencies by August 5, 2016.

The Proposed Rule aims to promote the stability of banking organizations covered by the Proposed Rule (“covered companies”) and across the U.S. financial sector by requiring covered companies to be in a position to fund themselves over a one-year time horizon. In the expectation that disruptions to a banking organization’s regular sources of funding may compromise its liquidity position, the Proposed Rule seeks to ensure that covered companies maintain sufficient liquidity profiles to support their activities in times of economic stress. The Proposed Rule is consistent with the October 2014[1] and June 2015[2] Basel Committee on Banking Supervision (“BCBS”) NSFR standards, and it complements the Agencies’ prior line of rules pertaining to liquidity management and liquidity risk for large banking organizations.[3] The Proposed Rule also reflects the goals of the Dodd-Frank Act, to promote the safety and soundness of the U.S. financial markets.

<u>Scope of the Proposed Rule</u>

Like the Agencies’ September 2014 liquidity coverage ratio (“LCR”) rule,[4] the Proposed Rule applies to:

(1) bank holding companies, savings and loan holding companies without significant commercial or insurance operations, and depository institutions that, in each case, have $250 billion or more in total consolidated assets or $10 billion or more in on-balance sheet foreign exposure; and

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[1] Basel III: The Net Stable Funding Ratio (Oct. 2014), *available at* http://www.bis.org/bcbs/publ/d295.pdf.
[2] Net Stable Funding Ratio Disclosure Standards (June 2015), *available at* http://www.bis.org/bcbs/publ/d324.pdf.
[3] *See* Enhanced Prudential Standards for Bank Holding Companies and Foreign Banking Organizations, 79 Fed. Reg. 17,240 (Mar. 27, 2014), codified at 12 CFR part 252; Liquidity Coverage Ratio: Liquidity Risk Measurement Standards, 79 FR 61440 (October 10, 2014), codified at 12 CFR part 50 (OCC), 12 CFR part 249 (Board), and 12 CFR part 329 (FDIC); Regulatory Capital Rules: Implementation of Risk-Based Capital Surcharges for Global Systemically Important Bank Holding Companies, 80 Fed. Reg. 49,082 (Aug. 14, 2015); Total Loss-Absorbing Capacity, Long-Term Debt, and Clean Holding Company Requirements for Systemically Important U.S. Bank Holding Companies and Intermediate Holding Companies of Systemically Important Foreign Banking Organizations; Regulatory Capital Deduction for Investments in Certain Unsecured Debt of Systemically Important U.S. Bank Holding Companies, 80 Fed. Reg. 74,926 (Nov. 20, 2015).
[4] Liquidity Coverage Ratio: Liquidity Risk Measurement Standards, 79 FR 61440 (October 10, 2014), codified at 12 CFR part 50 (OCC), 12 CFR part 249 (Board), and 12 CFR part 329 (FDIC).

(2) depository institutions with $10 billion or more in total consolidated assets that are consolidated subsidiaries of such bank holding companies and savings and loan holding companies.

In addition the Proposed Rule also applies to depository institutions that are the consolidated subsidiaries of covered companies and that have $10 billion or more in total consolidated assets. Separately, the Proposed Rule provides for a modified version of the NSFR requirements that would apply to bank holding companies and savings and loan holding companies without significant insurance or commercial operations that, in each case, have $50 billion or more, but less than $250 billion, in total consolidated assets and less than $10 billion in total on-balance sheet foreign exposure. Banking organizations with consolidated assets of less than $50 billion and total on-balance sheet foreign exposure of less than $10 billion are not subject to the Proposed Rule.

Net Stable Funding Ratio

Under the Proposed Rule, a covered company's NSFR would be expressed as a ratio of its available stable funding ("ASF") amount (the numerator) to its required stable funding ("RSF") amount (the denominator). The Proposed Rule would require a covered company to maintain a minimum NSFR of 1.0, wherein the ASF amount is no less than the RSF amount. The ASF amount is the weighted measure of stability of the company's funding over a one-year time horizon, calculated by applying standardized weightings ("ASF factors") to equity and liabilities based on their expected stability. The RSF amount is calculated by applying standardized weightings ("RSF factors") to assets, derivative exposures, and commitments based on their liquidity characteristics.

Available Stable Funding

The ASF amount reflects the stability of a covered company's equities and liabilities. Under the Proposed Rule, a covered company's funding profile would be considered stable over the NSFR's one-year time horizon if the ASF amount equals or exceeds the RFS amount (where the NSFR equals or exceeds 1.0). Categories of NSFR liabilities and NSFR regulatory capital elements are assigned an ASF factor, ranging from 0% (representing the lowest stability) to 100% (representing the highest stability), based on three characteristics relating to the stability of the funding, namely the funding tenor, funding type, and counterparty type.

Under the Proposed Rule, the NSFR would be calculated on a consolidated basis, though a covered company must account for certain restrictions when calculating ASF amounts from a consolidated subsidiary. Restrictions on the ASF of the consolidated subsidiary include those that restrict the availability of funding to support assets, derivative exposures, and commitments of the covered company held at entities other than the subsidiary. Where a covered company has an ASF amount from a consolidated subsidiary in excess of that consolidated subsidiary's RSF amount, the covered company would be able to include the excess ASF amount in its consolidated ASF amount only to the extent that the consolidated subsidiary may transfer assets to the top-tier of the covered company.

Required Stable Funding

The RSF amount represents the minimum level of stable funding that a covered company would be required to maintain under the Proposed Rule. The RSF factors used to determine the RSF amount are scaled from 0% to 100%, based on the liquidity characteristics of the covered company's assets, derivative exposures, and commitments. Relevant liquidity characteristics include credit quality, tenor, type of counterparty, market characteristics, and encumbrance. An RSF factor of 0% would not require the asset, derivative exposure, or commitment to be supported by ASF, while a factor of 100% would require full support of ASF.

The RSF weighting percentages are intended to align with the overall purpose of the NSFR rule, reflecting the idea that the less liquid an asset is over the NSFR one-year time horizon, the greater extent to which it would be required to be supported by stable funding. By requiring a covered company to maintain more stable funding to support less liquid assets, the Proposed Rule would reduce the risk that the covered company could be required to monetize the assets at a discount or in a manner that contributes to disorderly market conditions.

Derivative Transactions

Under the Proposed Rule, a covered company would calculate its RSF for derivative transactions separately from its RSF for other assets and commitments. The Proposed Rule would calculate the RSF for derivative transactions as defined in the LCR rule, reflecting the following three components of the calculation:

(1) the current value of a covered company's derivatives assets and liabilities;

(2) initial margin provided by a covered company pursuant to derivative transactions and assets contributed by a covered company to a central counterparty's ("CCP's") mutualized loss sharing arrangement in connection with cleared derivative transactions; and

(3) potential future changes in the value of a covered company's derivatives portfolio.

If the total derivatives asset amount exceeds the total derivatives liability amount, the covered company has an "NSFR derivatives asset amount," which would be assigned a 100% RSF factor. If the total derivatives liability amount exceeds the total derivatives asset amount, the covered company has an "NSFR derivatives liability amount," which would not be considered stable funding and would be assigned a 0% ASF factor.

Shortfall and Disclosure Requirements

In the event that a covered company does not maintain an NSFR of at least 1.0, or in the event that a covered company may potentially fall below 1.0, the Proposed Rule would require the covered company to notify its appropriate federal banking agency of the NSFR shortfall or potential shortfall no more than 10 days after the date of the shortfall or the event causing the potential shortfall. A covered company would also be required to submit a remediation plan and progress reports to show how it will become compliant with the minimum NSFR.

The Proposed Rule also includes disclosure requirements that apply to:

(1) covered companies that are bank holding companies and savings and loan holding companies; and

(2) holding companies subject to the FRB's proposed modified NSFR rule.

The disclosure requirements do not apply to depository institutions that are subject to the Proposed Rule. Those banking organizations that are subject to the Proposed Rule's disclosure requirements must provide public disclosures each calendar quarter, and such disclosures would need to remain publicly available for at least five years from the date of the disclosure.

Our Initial Take

As in the case of the liquidity coverage ratio, the detailed classifications in the Proposed Rule may or may not reflect market realities now or in the future. We expect that a final rule similar to the proposal is inevitable but there may be room for changes to some of the details.

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