The systemic risks of inhibiting collateral fluidity: Net Stable Funding Ratio

Background to the NSFR

In January 2014, the Basel Committee on Banking Supervision (BCBS) published a **Consultative Document on the Basel III Net Stable Funding Ratio**. The Net Stable Funding Ratio (NSFR) requires banks to maintain a stable funding profile in relation to the composition of their assets and off-balance sheet activities. It is intended to limit overreliance on short-term wholesale funding, encourage better assessment of funding risk across all on- and off-balance sheet items, and promote funding stability. The NSFR is designed to complement the Liquidity Coverage Ratio (LCR): while the LCR aims to promote the short-term resilience of a bank's liquidity risk profile under stressed conditions, the NSFR seeks to mitigate funding risk over a longer, more normalized time horizon.

Definition

The NSFR is defined as the amount of available stable funding (ASF) relative to the amount of required stable funding (RSF). The ASF is defined as the portion of capital and liabilities expected to be reliable over the time horizon considered by the NSFR, which extends to one year. The RSF calculation is a function of the liquidity characteristics and residual maturities of the various on- and off-balance sheet assets held by a specific institution. The ratio should be equal to at least 100% on an on-going basis. It is the intention of the Committee that the NSFR, including any revisions, will become a minimum standard by January 1st 2018.

Calculation and asymmetry

From the perspective of securities financing trades (SFTs), the NSFR provides for different ASF and RSF weightings (or 'factors') depending on the type of counterparty and the residual maturity of the transaction. These are summarized in the below table:

Counterparty type and tenor	ASF factor	Counterparty type and tenor	RSF factor
Any funding ≥ 12 months	100%	Bank < 6 months	0%
Public sector < 12 months	50%	Bank 6-12 months	50%
Central Bank 6-12 months	50%	All non-banks < 12 months	50%
Bank 6-12 months	50%	Banks > 12 months	100%
Any funding < 6 months	0%	Non-banks > 12 months	100%

What stands out, and which was not included in the original 2010 framework for the NSFR, is the 50% RSF factor to be applied to all loans (including reverse-repos) to non-banks, regardless of the residual maturity of the transaction, and independent of the underlying asset. In other words, this would mean that all reverse-repos with non-banks under one-year maturity would require the provision of stable funding against 50% of the value of the reverse-repo. For example, a bank transacting a $100 million overnight reverse in AAA government bonds with an insurance company or hedge fund would carry a requirement for $50 million of (long term) stable funding, even if this reverse was match-funded by repo.

Why this asymmetry?

It would seem that this asymmetric treatment between banks and non-banks for reverse-repos is quite deliberate, and is designed to reduce the availability of leverage to non-banks (particularly hedge funds) as well as to mitigate the risks associated with large repo matched-books.
However, in terms of being the right tool to meet its objectives, the NSFR is inherently flawed. It falls short in a number of ways:

- It does not distinguish between the underlying assets. High quality liquid assets (HQLA) carry the same RSF factor as non-HQLA. This seems to be inconsistent with the Liquidity Coverage Ratio.
- It does not provide for central counterparties (CCPs). It is not clear whether these should be treated as banks or non-bank financials. The same uncertainty applies to broker-dealers.
- It does not draw a distinction between securities borrowed to cover firm shorts (and which supports secondary market-making), those that are reversed for liquidity management, and those that are pure matched-book funded.
- It does not distinguish between non-bank counterparties that are leveraged and those that are 'real-money'.

What will be the impact?

The BCBS has indicated that any qualitative responses to the consultation should be supported by a thorough quantitative impact study (QIS). It is not clear whether the BCBS conducted such a QIS itself when calibrating the ASF and RSF factors. The deadline for responses to the proposed framework is April 2014 – less than three months after the new framework was published.
Part of the challenge in quantifying the potential impact of the asymmetric treatment of reverse-SFTs with non-banks is being able to obtain the necessary data to support meaningful analysis. This would require, across all regions, ascertaining: what portion of all SFTs are with non-banks; how much of this is with CCPs and broker-dealers (which may or may not be classed as non-bank financials); how much is to cover firm shorts, and how much is matched-book funded; and how much of this is against HQLA. None of this data is readily available.

Then there is the challenge of establishing the additional cost that the RSF weighting will add to this segment of SFT activity. This will depend on individual banks' funding structures and medium-to-long term funding costs. But it is safe to assume that factoring in the cost of stable funding to a low-margin short-term reverse in AAA government bonds with a non-bank will be significant. Potentially, such trades may become economically unviable.

What is clear is that the proposed asymmetric treatment of funding for non-banks has the potential to impact a significant segment of the global SFT markets. This is likely to widen spreads and reduce liquidity in secondary bond markets, which will increase costs for debt issuers, not least sovereigns. In turn, this will have an impact on government spending and taxation in the real economy. Quantifying this impact demands careful and detailed analysis by the BCBS, the banks, and others. To push ahead with the NSFR without such analysis would seem to be an unwarranted risk.