

The Net Stable Funding Ratio – A Few Questions

On April 26, 2016, the FDIC and OCC released a draft proposal for a new, additional, liquidity regulation – the net stable funding ratio (NSFR) – and requested public comment. On May 3, 2016, the Federal Reserve Board will hold an open meeting at which they are expected to discuss and consider the same NSFR proposal. Open Board meetings are open to the public, but the public doesn't get to ask questions. There are definitely a few worth asking. Here are four.

1) On what conceptual basis are the NSFR and its key components calibrated?

The NSFR is defined as the ratio of “available stable funding” to “required stable funding,” and banks are required to maintain a ratio above one. Available stable funding (ASF) is determined by taking each bank liability, multiplying it by an ASF factor, and then adding up all the resulting, weighted numbers. Required stable funding (RSF) is similarly defined by summing bank assets weighted by RSF factors.

As the ASF and RSF factors have weights that range between 0 and 100 percent, those weights are obviously crucial to determining the types of liabilities and assets preferred by the rule, and therefore are given an incentive to hold. Unfortunately, the proposed rule only explains the ranking of the weights. A liability is considered less stable, and so gets a lower ASF, if there is a greater likelihood that the bank will have to replace or repay it over the NSFR's one-year time horizon. Similarly, an asset requires less stable funding, and so gets a lower RSF, the greater the extent to which the bank can liquidate the asset over the NSFR's one-year time horizon. That makes sense as a general matter, but does nothing to explain how particular weights were derived. For example, the rule requires banks to maintain “stable” funding equal to 15 percent of short-term loans to financial businesses and 50 percent of short-term loans to small businesses. While the rule explains why the RSF for short-term loans to financial firms should be lower than the RSF for short-term loans to small businesses, it doesn't address the more important question of “Why 15 percent and 50 percent, rather than two other numbers?” By contrast, the proposal for the liquidity coverage ratio (LCR) – the other liquidity regulation contained in Basel III – specified the exact characteristics of the 30-day stress scenario that defines the cash inflow and outflow rates that are the analogues of the ASFs and RSFs in the NSFR.

Confusingly, the NSFR proposal says the ASFs and RSFs are intended to reflect “all market conditions,” but also specifically says they are not intended to be based on a market stress environment. And the proposal cannot possibly be based on ordinary market conditions – because in those conditions nearly all liabilities are stable, and weightings would vary little if at

all. So it appears that the NSFR components are calibrated to something between normal condition and stressed conditions – but precisely where, the proposal does not say.

Without a clear conceptual basis, there is no way to evaluate whether the NSFR accomplishes its objective, or even have a constructive dialogue about its calibration. By contrast, when the agencies requested public comment on the LCR and the stress scenario to which it was calibrated, the public provided information on how specific bank assets and liabilities actually behaved during past stress periods with the characteristics specified, and the calibration of the regulation was adjusted in response. When the calibration of the regulation is only defined vaguely, we can only ask if it is consistent with other regulations or is internally consistent.

2) Why are the ASF and RSF factors that define the NSFR inconsistent with the calibration of the LCR?

The LCR is defined over a 30-day horizon and the NSFR is defined over a one-year horizon, so the NSFR would seem to have to be based on a less severe underlying scenario than the LCR. So why does the LCR assume a bank can liquidate all of its Treasury securities within 30 days but the NSFR assume a bank can only liquidate 95 percent of its securities over a year? Why does the LCR assume that a bank receives all of its unsecured short-term lending back within 30 days while the NSFR assumes that a bank only gets 85 percent back? There are more examples.

3) Are all the ASF and RSF factors consistent with one another - that is, are they each derived from the same, albeit unstated, conceptual basis?

This question is important across the whole range of ASF and RSF factors. For example, as noted above, a bank is assumed to be able to monetize 95 percent of its unencumbered Treasury securities. But the RSF for Treasury securities that are encumbered for between six months and one year is 50 percent. Presumably, the bank can monetize none of the securities while they are encumbered and 95 percent of them once they become unencumbered, so why 50 percent? If 50 percent is meant to be an approximate average of the availability over the one-year horizon, then why are most other ASFs and RSFs defined to reflect the situation at the end of the horizon rather than an average over the horizon? Shouldn't they also be defined as averages of the available or needed funding, respectively, of that component over the one year horizon?

4) More fundamentally, is the NSFR even necessary?

Since its proposal, the regulatory agencies have put in place multiple new measures, including a requirement that banks conduct on a monthly basis stress tests across 30-day, 90-day, and one-year horizons, that address the same concerns as the NSFR. The need case for the NSFR in this broader regulatory context should be clear and unambiguous. What funding risk has been left unaddressed by existing regulation, and thus left for the NSFR?