Basel III breakfast briefing series

Stretched to the limit: Dealing with the implications of the NSFR

As the Net Stable Funding Ratio (NSFR) moves to the centre of the radar, there are growing concerns that it will have a disproportionately costly and disruptive impact on repurchasing agreements (repo), derivatives and trade finance. What challenges does the NSFR present, how do they interact with other incoming changes and how does your bank manage the impact on funding costs, maturity transformation and other fundamental aspects of your business model?

The NSFR has tended to take a back seat to other more immediate demands of Basel III. But the recent consultation on NSFR, new liquidity reporting requirements and the imminent introduction of the Liquidity Coverage Ratio (LCR) (see Figure 1) are now focusing minds on liquidity, funding and the NSFR's place within their management.

The NSFR is set to have a powerful impact on the prices, profitability and even viability of certain core business lines (see Figure 2). Indeed, some banks could find that the new funding demands are harder to meet than capital adequacy requirements. While implementation of the NSFR is not due until 2018, it's vital that banks understand how it could affect their businesses and seek to avert any unintended consequences in the remaining time before the rules are finalised.

Assets: Impact of NSFR

Asset category	Increase/decrease	NSFR impact
Mortgage loans (35%)	↑	Requires relatively less stable funding than unsecured
Short-term loans	↑	Requires less stable funding than long-term
Long-term loans	↓	Requires more stable funding than short-term
Derivatives	↓	Requires more stable funding

Liabilities: Impact of NSFR

Liability category	Increase/decrease	NSFR impact
Own funds (equity)	↑	Source of stable funding
Deposits: Individuals, SME	↑	Stable funding
Deposits: Other	↓	Less stable funding than other deposits
Capital markets: Long-term	↑	Stable funding
Derivatives	↓	Not considered as stable funding

Industry concerns

The NSFR aims to reduce over-reliance on short-term funding by ensuring that banks hold a sufficient amount of stable funding (e.g. equity, long-term debt and deposits) to match the maturity characteristics of their different business activities. Weightings are assigned to particular types of assets and liabilities according to what the Basel Committee deems to be their funding risk. Banks then need to make sure that they have sufficient 'stable funding' to match their funding–weighted assets.

The calibration of these weightings was revised earlier in the year. Bankers attending a recent PwC–hosted round table on the latest developments in NSFR generally felt that the impact on retail banking is likely to be easier to manage, especially as most have already improved their deposit levels and switched to sources of longer term (more expensive) funding.

Investment banking is a different matter. Several of the round table participants felt that secured financing transactions (SFTs) are set to be unduly penalised because they are mainly with non-banks, while the treatment of derivatives is still very unclear. Particular concerns centre on repos. Transactions with non-bank financial counterparties would attract a 50% weighting in the same way as unsecured lending even if backed by highly rated securities. Prices for this important source of liquidity for the financial system are therefore likely to rise or supply is likely to fall. Unregulated lenders may also step in to cover any resultant shortfall in the supply of repo funding for trading.

Central clearing houses would count as non-banks under the NSFR and, therefore, short- term banks transactions with clearing houses could require 50% weighting compared to 0% for an uncleared exposure to a bank counterparty. This runs counter to the regulatory push for central clearing. Further jolts to the 'real economy' could come from the 50% weighting for trade finance, despite the limited duration of these transactions.

Simplicity versus complexity

So does the NSFR reflect the real funding risks being borne by investment banks? Many regulators want to see simple common standards applied across the industry to help strengthen transparency and comparability. But most round table participants felt that while the NSFR provides a good fit for the assets and liabilities of a traditional banking business, it's too simplistic to reflect the complexities within investment banking.

Most participants would prefer more refined and graduated NSFR evaluations, even if this means applying different metrics to retail and investment business. If a standardised approach is used, one of the consequences is likely to be a regulatory requirement for banks to produce ICAAP-style self-assessments for regulators to get a better handle on the real funding risks being run within individual banks.

Accounting mismatch

The difficulties created by the latest proposals are compounded by the need to apply balance-sheet-based funding and liquidity measures rather than the normal cash flow approach to asset and liability management that banks use to manage their businesses. If banks use different accounting standards, their NSFR measures won't be comparable. For example, if two banks bear the same funding risks, but if one reports under IFRS and the other under US GAAP, then their NSFRs could be markedly different. This means that the goals of global consistency, greater transparency and improved market discipline may not be achieved.

Bigger picture

What makes the NSFR even more challenging is its place within a bigger and not always compatible jigsaw of incoming regulatory changes. The NSFR is often mentioned in the same breath as the LCR. But it also interacts with the leverage ratio, risk-weighted assets and recovery and resolution planning (RRP), along with imminent changes to accounting rules. It is also unclear what action supervisors will require banks to take when the NSFR is below 100% and over what timescale.

As ever, frontline business teams want clear answers on what all these changes mean for the business they're transacting. But just like an engine, tuning up or re-calibrating one part could have a knock on impact on other components. For example, it might be possible to improve the NSFR by netting derivative positions via a centralised payment agent. But this could be challenged by regulators in the context of RRP.

The way forward

The good news is that there is still time to influence and reshape the proposals. The round table discussions highlighted the value of evaluating how different businesses would perform under the different NSFR calibrations that will emerge during the coming rounds of deliberations and refinements. It's also important to remember that the EU may modify the approach for NSFR under CRD IV. Scenario analysis can help banks understand where unintended consequences are likely to arise and consider responses for different potential outcomes. It's still probably too early to put these plans into action, but it's important to have the response ready.

There are three possible options for dealing with the NSFR, though the roundtable concluded that only one is really viable. Your bank could reduce the volume of NSFR-unfriendly transactions, but this would erode credibility within the market. You could reduce the asset-liability mismatch and hence the NSFR by reducing the tenor of assets. But this is likely to be a non-starter as clients will continue to dictate the length of maturity of loans and will look to alternative funding sources if you or other banks can't meet their needs. That leaves extending the maturity of liabilities as the most viable option – particularly for mortgage banks. The macro-economic and capital markets consequences of the maturity extension could be significant.

Engagement with politicians and regulators is likely to be most effective when it highlights the impact on businesses, employees and consumers. Lengthening the duration increases funding costs. These costs may be passed on to customers through increased prices for banking services. The current NSFR proposals could also increase systemic risk by shifting ever more finance and funding to the 'shadow' (currently unregulated) sector.

Prepared for what's coming

The move to the NSFR opens up huge questions over how banks are funded, how the associated risks are managed and the competing merits of simplicity versus complexity in regulating an inherently complex banking sector.

We believe there are three key actions to make sure your bank is ready to deal with the implications of the NSFR:

1. Evaluate the impact on 'penalised' areas such as trade finance, secured lending and other business caught in the NSFR net.
2. Assess the implications of NSFR calibrations and how they interact with other regulatory measures and accounting changes. Set associated performance envelopes for the business.
3. Determine how you can minimise the impact of the NSFR on maturity transformation to optimise your business model.

Giving you the edge

PwC is helping a range of banks to get to grips with the practicalities of the NSFR and wider regulatory developments. If you would to know more about the latest NSFR proposal and how they could affect your business, please call your usual PwC contact or one of the regulatory team leaders listed here:

Contacts

Richard Barfield
T: +44 (0) 20 7804 6658
E: richard.barfield@uk.pwc.com

John Elliott
M: +44 (0) 7730 147799
E: john.elliott@uk.pwc.com

Hortense Huez
T: +44(0)20 7213 3869
E: hortense.huez@uk.pwc.com

www.pwc.co.uk/fsrr

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