AFME Position Paper

CRD 5: The Net Stable Funding Ratio

April 2017

Introduction

AFME and ISDA welcome the concept of a longer-term measure of structural liquidity. We strongly support the underlying policy goals of the NSFR, including its core objective of requiring banks to develop and maintain sustainable funding structures. We continue however to have significant reservations on the proposed NSFR standard with respect to its impact on capital markets, including the severe restrictions it creates on banks' ability to provide market services which facilitate client financing, investing and hedging. This is notwithstanding some of the initial positive steps that the European Commission ('EC') has taken in reducing the charges for repos and improvements in the calculation of funding charges for derivatives. Without further adjustments to the proposed framework, the NSFR might impair the viability of the Capital Markets Union and increase volatility and systemic risk.

We have noted the analysis that the European Banking Authority ('EBA') has undertaken on the NSFR but we feel that this is incomplete in several important areas. In particular, any evaluation of NSFR impacts in Europe must consider how banks allocate regulatory capital, funding and liquidity costs internally within their organisations, as required by BCBS standards.

We have, therefore, undertaken our own industry study on the impact of the NSFR on capital markets activities. This shows that the application of the BCBS standard would result in an extremely high regulatory long term funding requirement for capital markets activities and at a cost to the industry that is very significant in comparison to global GSIB revenues.

According to the study, NSFR deficits arise mainly in connection with capital markets activities rather than with commercial banking business. Retail/commercial banks that may have NSFR 'surpluses' but are without existing capital markets franchises will almost certainly be unable to expand into markets businesses and substitute for reduced capacity. Acting as a market maker in capital markets requires major fixed cost infrastructure investment in technology, trading expertise, risk management expertise, and product development and a bank primarily operating in retail markets would not be able to become a market maker without a costly strategic expansion into such activities. And of course, if such a bank were to succeed in expanding such businesses, the same issues that now affect significant market makers would begin to affect it. Finally, uncertainty around the final outcome of the Banking Structural Reform package will certainly dissuade attempts to broaden franchises.

While banks and end-users may (or may not) be able and willing to absorb some incremental cost increases in capital markets services the larger effect will be a contraction of financial markets activity and increased financial market volatility. If the cumulative effects of the NSFR and other requirements are not manageable, banks will reduce their inventories, thus impairing market liquidity. Less liquid markets in turn will reduce issuers' access to investors through reduced participation, less efficiencies and increased costs. This would imperil the intentions of EU policymakers to foster deeper and more liquid EU capital markets to support the creation of a Capital Markets Union.

Instead, we consider that the alternative treatments recommended below offer a more conceptually sound, risk-based and realistic way forward for the implementation of the NSFR. The recommendations would still require very significant long term stable funding at a substantial cost, but in contrast to the application of the CRR standard in its current form, are less likely to call into question the viability and provision of capital market and derivative products, and financial stability. We would be very pleased to work with policymakers to seek the best ways in which these might be implemented.

We set out below the main shortcomings of the standard as it is currently proposed, which leads to the large funding deficits for capital market activities, together with the alternative treatments we recommend be adopted in the EU implementation of the NSFR.

Derivatives Funding Requirement

The calibration of the combined derivatives funding required requires reconsideration in light of implementation within Europe. We believe that unless the rules are revised, the current requirements could severely impact the availability and pricing of hedging products for end users, and negatively impact the development of robust capital markets. End users use derivatives to hedge their risks and any rules that could constrain the use of derivatives, may: (i) impact companies' ability to hedge their funding and currency risks on both newly issued debt and banks loans; (ii) hinder infrastructure projects capacity to eliminate mismatches between their revenues and liabilities, thus making such assets less attractive and less safe from an investment perspective; (iii) constrict companies' ability to hedge their commercial and day-to-day risks resulting in a weakening of their balance sheets, uncertainty in financial performance, and more expensive funding; (iv) obstruct cross-border capital flows; (v) impede investors looking to hedge the risks inherent in capital markets instruments and their ability to provide sufficient returns to policyholders; and (vi) disrupt flows of foreign direct investment. By failing to differentiate the economic purpose, funding profile and underlying risk exposure of certain derivatives portfolios, the BCBS NSFR introduces frictional costs for derivatives transactions that are disconnected from actual funding risk considerations.

To mitigate this risk, AFME and ISDA welcome the EC's proposal for the recognition of all cash variation margin received, and we support the EC's proposed recognition of Level 1 HQLA as received variation margin. We, however, also believe that rehypothecable (re-usable) initial margin be recognised as providing funding value.

Regarding the EC's proposals to account for future funding risk, we believe this to be a crucial issue given its potential to significantly negatively impact the liquidity of derivatives markets. We think the EC has taken a step in the right direction and are appreciative of the will to try and implement a more risk sensitive approach by allowing the option to use SA-CCR for margined derivatives instead of applying a flat 20% notional-based funding factor on derivatives liabilities. But this approach has not been assessed and tested. No one knows what kind of numbers its going to produce. We know that the BCBS 20% add on, according to an ISDA/AFME study, will result in an estimated funding requirement of €340billion for the entire industry. But it is by no means certain that the alternative proposed by the EC will result in lower numbers, and therefore the measure could have a similar negative effect on the liquidity of derivatives markets and access to hedging instruments. We believe that the EC proposals for the treatment of margined derivatives needs to be properly impacted tested before becoming a binding measure[1]. If not we could end up with another inappropriate funding measure. In addition, we believe the flat 10% required funding factor add on for unmargined derivatives is inappropriate and grossly overstates the true funding requirements associated with the uncollaterised netting sets.

[1] Joint Associations' work on the alternative to a 20% add-on for derivative liabilities in is progress and we hope to be able to share this in the near future.

Securities Hedging

As mentioned, end users may wish to gain exposure to securities for a variety of reasons. Banks play an important role in providing end-users with this exposure but must hedge the risk of the transaction by purchasing the underlying. For example, an asset manager may require exposure to equity stock, which the bank will provide to the client, by purchasing the stock to hedge the position from a market risk perspective. The calibration of the securities RSF within the NSFR (e.g. up to 85% RSF) fails to take into account the short-term nature of hedging instruments and the legal and operational provisions in place which ensure the close out price is fully absorbed by the client.

We would therefore recommend the application of a 0% RSF factor to securities that are hedging a derivative on which initial margin has been provided and less penal RSF factors for securities that are hedging other derivatives.

Securities Market Making

The NSFR, if implemented in its current form, could have unintended consequences for primary and secondary dealing in securities. Market makers in equities and other securities, such as corporate debt and securitisations, face extremely penalising long term funding charges (e.g. 50- 85% RSF) under the NSFR. Whilst appropriate for the LCR, which is a short-term stress metric, the replication of these haircuts within the NSFR as a structural measure is not logical and risks jeopardising the market-making function of banks in these securities; a function which is vital for supporting real-economy end users who rely on an active and sizable market for financing.

We therefore support the EC's application of a 0% RSF for high quality sovereign securities to support market liquidity.

Asymmetrical treatment of repos and reverse repo

While the calibration of the funding requirement for reverse repos is a notable improvement from the previous versions of the NSFR, the 5-10% RSF on reverse repo transactions imposes a levy which will undoubtedly restrict the ability of banks to provide market liquidity for sovereign and other securities. The International Capital Market Association (ICMA) noted in their recent paper entitled "Impacts of the Net Stable Funding Ratio on Repo and Collateral Markets" that "*the impact of the NSFR, if simply adopted exactly as outlined by the BCBS, would create significant additional stress and weaken the effectiveness of the market. Given the role of repo and collateral markets at the heart of the financial system, this would have negative implications for the smooth functioning of broader financial markets – which would, in turn, lead to increased costs and risk for market participants, including those corporates and governments borrowing to finance their economic needs.*

We therefore continue to recommend the adoption of a 0% RSF factor for reverse repo transactions which are collateralised by Level 1 HQLA.

Client and firm short coverage

Banks play a vital role in facilitating market liquidity for securities by executing long and short positions on behalf of both clients and the firm. Short sale proceeds from clients receive no stable funding recognition in the NSFR (0% ASF), regardless of the franchise nature of this business. However, when the bank reverses in stock to cover the short, this receives a punitive 5-10% RSF even though the short sale proceeds fully fund the transaction. Firm short coverage, on the other hand, is an entirely self-funding activity e.g. stock is sold short and the firm reverses in collateral to cover the position.

We suggest the application of a 0% RSF factor to cash collateral provided to counterparties for the purpose of covering client shorts.

Segregated client assets

The NSFR penalises segregated cash accounts maintained by a bank as an unaffiliated custodian with a 15% RSF factor while giving no ASF recognition to the client payables that effectively fund such segregated assets.

In our view, there should be an elimination of the asymmetry to reflect the 'pass through' nature of the business.

Client Clearing transactions

Our members welcome the EC's classification of derivatives client clearing activities as giving rise to interdependent assets and liabilities. However, firms may still have segregated assets on their balance sheets related to non-derivatives client-cleared positions. Even though clients directly fund these positions—the bank's balance sheet serves as a custodian or intermediary—the NSFR would nonetheless impose funding charges on these positions, placing a regulatory tax on market access.

Off balance sheet collateral swaps

Banks source collateral in a variety of ways: through outright purchase, secured borrowing, rehypothecable margin received or asset exchanges e.g. collateral swaps. Collateral swaps, where the bank receives collateral which is of higher quality than the collateral posted, in a term transaction, receives no ASF value in the NSFR despite being akin to a repo. This treatment risks disincentivising off-balance sheet asset exchange activity, which is a vital component of market liquidity for securities.

To mitigate this risk, there should be ASF recognition for collateral swaps of greater than one year where the bank has received higher quality collateral.

Other/Further Issues

Prime brokerage: We consider that there should be an allocation of more realistic RSF factors to reflect the lower risk nature of prime brokerage transactions owing to the short-term nature and the extent of the collateralisation involved in many services.

Factoring: There is no specific treatment given for factoring exposures and we would recommend the application of trade finance RSF factors to this business.

Use of Delegated Acts: It is envisaged that very significant and resource intensive aspects of the proposed standard, including the treatment of repos and derivatives, will be passed to the European Banking Authority for further analysis and quantitative assessment before Delegated Acts are implemented to introduce the relevant aspects of the new standard. These Delegated Acts may not be completed for potentially up to five years after the publication of CRDV in the Official Journal. Instead, we believe NSFR treatments should be fully assessed, understood and agreed before the application of any aspect of the standard. There should not be a need therefore for interim treatments or Delegated Acts which would lead to uncertainty and pricing difficulties.

Areas of super-equivalence to BCBS standard: The EC is seeking to implement super-equivalent areas to the BCBS standard which would unnecessarily constrain EU banks. These areas have not been subject to an impact analysis and some are technically flawed. In particular:

i) The automatic application of more stringent third country treatments does not allow scope for the analysis of their appropriateness or suitability; and,

ii) The restriction and reporting of currency mismatches is not meaningful owing to the treatment of FX derivatives where no ASF is permitted and a swap position will be shown only as a marked to market value.

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About AFME

AFME represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. We advocate stable, competitive, sustainable European financial markets that support economic growth and benefit society. AFME is the European member of the Global Financial Markets Association (GFMA) a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association (ASIFMA) in Asia. AFME is listed on the EU Register of Interest Representatives, registration number 65110063986-76

About ISDA

Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has over 850 member institutions from 66 countries. These members comprise a broad range of derivatives market participants, including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure, such as exchanges, intermediaries, clearing houses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association's website: www.isda.org.