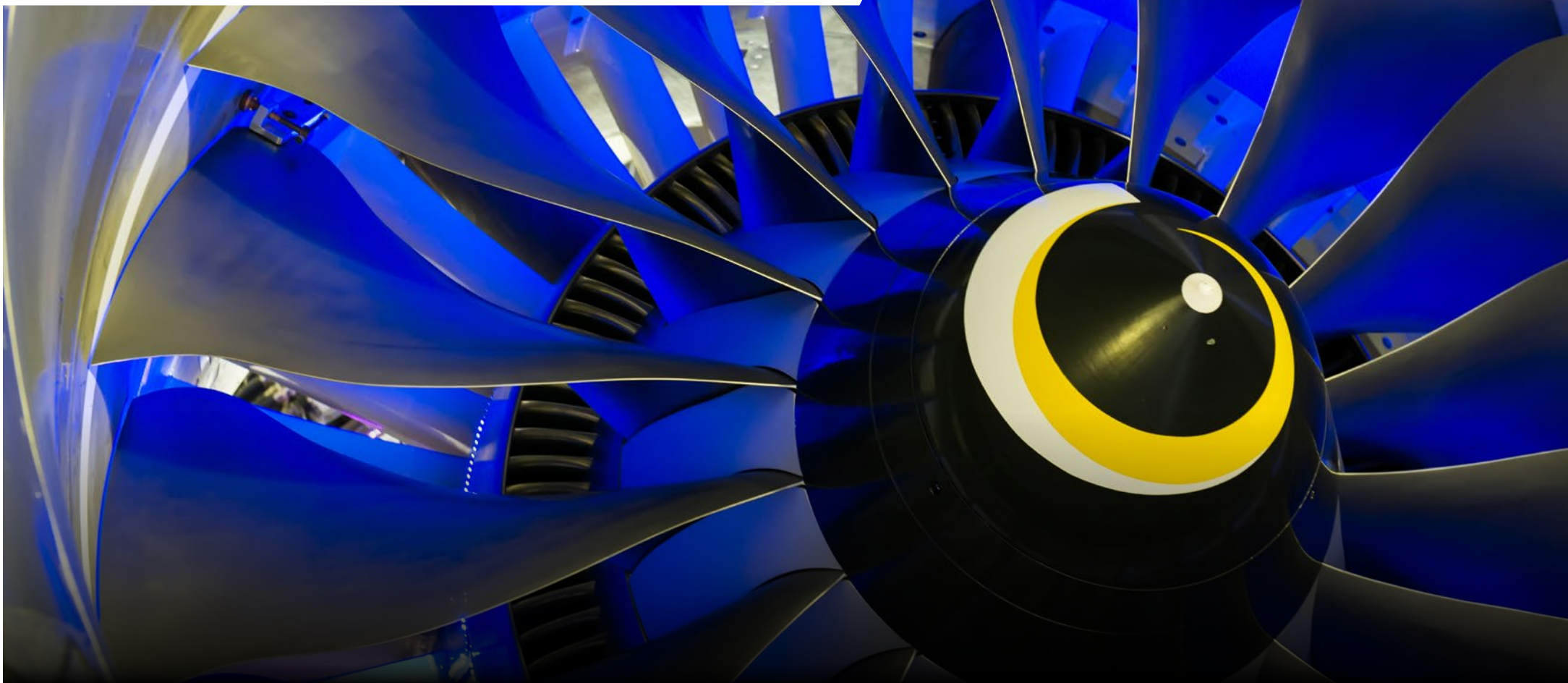


NSFR and implications for Equity Markets



NSFR

The Net Stable Funding Ratio (“NSFR”) forms an important element of the European Commission’s CRD5/CRR2 proposals and will require banks to maintain a stable funding profile in relation to the composition of their assets.

AFME welcomes 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 will create 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 (CMU) and increase volatility and systemic risk.

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Banks’ role in equity markets

Banks perform several critical functions to support EU equity markets, ranging from underwriting to market making. Equity swaps offered by banks to investors are a common and cost efficient way to gain exposure to equities without holding underlying securities.

The NSFR rightly seeks to increase long-term funding for banks, and to reduce excessive reliance on short-term funds. However, the NSFR applies a punitive long-term funding requirement to equity securities, held in banks’ inventories as hedges to the equity swaps provided to market participants, despite their short term nature. This is illustrated in the case study on the next page.

Equity swaps: what are they and why are they important?

Equity swaps are a very common and efficient way for institutional investors, asset managers and pension funds (e.g. life insurers and mutual funds) to gain exposure to assets without holding underlying cash securities. In practice: Investors enter into a derivative contract (a swap) with a dealer to receive the performance on an individual or basket of selected cash securities.

This solution is often operationally more efficient and less expensive for investors, in a context of fragmented markets (e.g. diverging access and settlement rules). It also allows investors to track a basket of stocks or a benchmark without the difficulty of having to physically buy the (potentially many) individual stocks.

The bank acting as a dealer in this transaction is not interested in having the exposure to those stocks: its client (the investor) wants to have it, not the bank. Therefore the bank hedges its market risk by purchasing the reference assets and holding these assets for the life of the generally short-dated transaction.

Equity exposure via equity swaps is the dominant form of equity financing in Europe given the heterogeneity of EU markets. The notional value of equity-linked contracts outstanding as at June 2016 was \$6.6 trillion, of which \$2.2 trillion linked to European equities (nearly the GDP of France) [Source: BIS].



Case study: Equity Swaps Hedge

Step 1 – An institutional investor seeks equity market exposure

A European institutional investor seeks equity market exposure to meet its investment objectives (i.e. diversification of the portfolio; optimal returns; mitigation of risks).

The institutional investor enters into a one month equity swap contract (for 100 EUR notional) with a bank to receive the performance from a security (e.g. Orange S.A.), in exchange for the short-term financing cost (i.e. interest rate + spread; e.g. Euribor + 25bps). The institutional investor will receive the performance of the Orange S.A. stock (e.g. change in value of the Orange S.A. security) through the equity swap.

Step 2 – The institutional investor provides initial margin to the bank under the contract and receives the performance of the stock

The institutional investor provides initial margin (e.g. IM 20 EUR) to the bank under the contract and receives the performance of the stock.

The client's initial margin reduces the bank's credit risk if the client defaults. The bank is able to use the initial margin during the contract of the swap; the initial margin is therefore a source of funding for the bank.

Step 3 – The bank hedges market risk arising from the client-facing equity swap

To hedge the market risk on the swap, the bank purchases the reference asset e.g. Orange S.A. stock and holds it for the duration of the swap.

When holding the Orange S.A. securities as a hedge under the NSFR the bank applies a 50% RSF factor, even though the client's initial margin (i.e. step 2) funds part of the Orange S.A. security, and the security is held only for hedging purposes. The additional cost of holding the hedge due to the long-term funding required will likely impact the portfolio returns of the institutional investor (e.g. spread requested by the bank is likely to increase due to NSFR cost).

Step 4 – The institutional investor client seeks to terminate the swap and all positions unwind

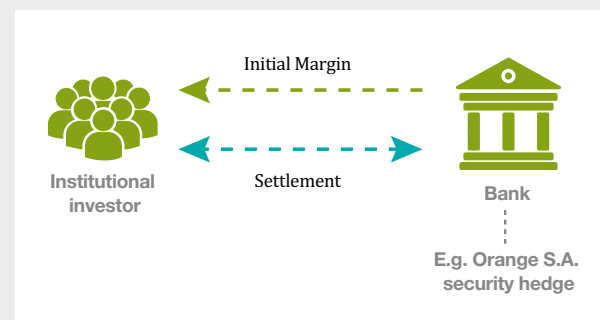
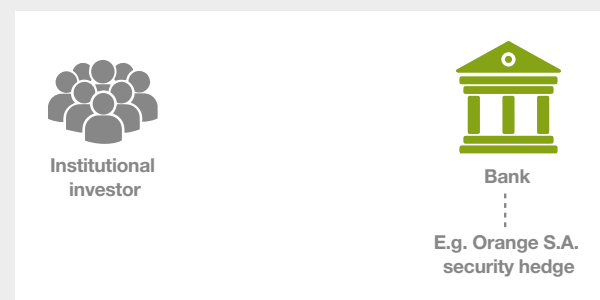
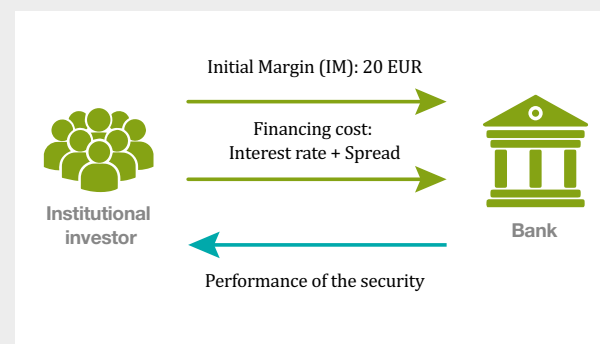
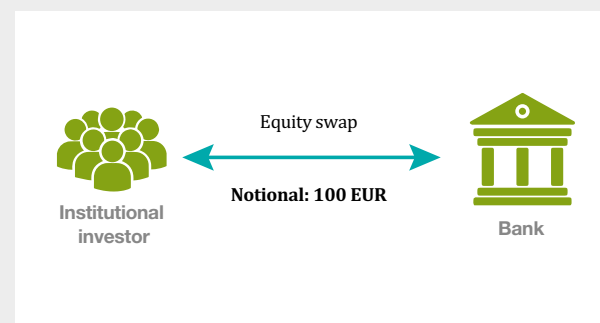
At the swap's termination, the bank sells the Orange S.A. security since market risk from the swap is eliminated, the bank returns the initial margin to the client and the swap is settled.

How to achieve a more proportionate treatment?

The NSFR currently imports LCR stress haircuts for equity securities held on balance sheet, namely 50% for non-financial shares and 85% for financials. Given the more structural (and not stressed) nature of the NSFR, a lower RSF for equity securities held as hedges would be justified.

In particular, a 0% RSF should apply where the securities held by the bank are one-to-one direct hedge and the bank has received Initial Margin (IM) from the client. The IM will either fully or partially fund the transactions. If the bank has not received IM, or to the extent to which the IM does not fund the purchase of the security, then more realistic RSFs of 15% or 30% should apply depending on the quality of the securities, i.e 15% for level 2B equity securities and 30% for non-HQLA equity securities.

A separate table is available and provides a detailed proposal for recalibration. These recalibrations would better capture actual funding requirements and risks and would solve a major regulatory impediment to vibrant equity markets within the CMU.



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