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Finance for Europe

Association for Financial Markets in Europe

# AFME Position Paper

## CRD 5: The Net Stable Funding Ratio

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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 current BCBS 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. These reservations lead to a conclusion that, in its current form, 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.

It can be noted from our study that NSFR deficits arise mainly in connection with capital markets activities rather than with commercial banking business. Contrary to what might be thought at first glance, banks that may have NSFR 'surpluses' but are without existing capital markets franchises will almost certainly be unable to meet capital markets demand through expansion into markets businesses. 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.

While end-users may (or may not) be able and willing to absorb some incremental cost increases, which cannot be the prudential objective of the NSFR, 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 NSFR and other requirements are not manageable, a bank will reduce its inventories, thus impairing market liquidity. Less liquid markets in turn will reduce issuers' access to investors through reduced participation, less efficiencies and increased costs.

Instead, we consider that the alternative treatments we propose[1] offer a more conceptually sound and realistic way forward for the implementation of the NSFR. They would still require very significant long term stable funding at a substantial cost, but in contrast to the application of the BCBS standard as it is, are less likely to call into question the viability and provision of capital market and derivative products, and financial stability.

[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.

We set out below the main shortcomings of the BCBS standard which lead to the large funding deficits for capital market activities together with the alternative treatments we recommend be adopted into 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. In particular, the recognition of variation margin received by banks, which has been aligned to the Leverage Ratio, is inappropriate in a long term funding standard. The restriction on the netting of securities variation margin, and the application of the leverage ratio netting rules for cash variation margin, could severely impact the availability of derivatives for end-users. The application of the 20% charge for derivative liabilities, in its current form, compounds this issue.

End users, such as corporates and pension funds, use derivatives to achieve a wide range of economic objectives. For example, end-users may need to gain exposure to a specific asset class, such as government bonds to hedge interest rate or inflation risk. 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. Existing studies demonstrate that the BCBS NSFR framework, if imposed in its current design, would result in significant additional costs to derivative end-users.

To mitigate this risk, AFME would suggest the recognition of all cash variation margin received, recognition of the full value of qualifying securities received as collateral subject to LCR HQLA based haircuts and, a reflection of the value of re-usable initial margin. There should also be the deferral of the adoption of a charge for derivative liabilities until a full assessment and observation of potential implications of alternatives can be assessed.

**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. 5-85% 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 client facing derivative on which intimal margin has been provided and RSF factors based around maturity adjustments for securities that are hedging other client facing derivatives.

**Securities Market Making**

The NSFR, if implemented in its current form, could have multiple 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 bares no logic 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.

AFME therefore recommends the application of a 0% RSF for high quality sovereign securities to support market liquidity and a review of the RSF factors applied to other securities.

**Asymmetrical treatment of repos and reverse repo**

Whilst the calibration of reverse repo is a notable improvement from the previous BCBS standard, the 10-15% RSF on 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 would therefore recommend the adoption of a 0% RSF factor for repo transactions with regulated financial institutions.

**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 10-15% 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.

AFME suggests the application of a 0% RSF factor to cash collateral provided to securities lenders.

**Segregated client assets**

The BCBS 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**

Client clearing firms are impacted by the BCBS NSFR in two ways. First, these firms may have segregated assets on their balance sheets related to client-cleared positions. Even though clients directly fund these positions—the bank's balance sheet serves as a custodian or intermediary—the BCBS NSFR would nonetheless impose funding charges on these positions, placing a regulatory tax on market access. Second, the BCBS NSFR is not clear as to whether RSF charges in connection with initial margin posted by the bank to CCPs on behalf of

client positions would apply. European implementation should provide clarification that a 0% RSF will apply to initial margin posted by a bank in client clearing transactions.

**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.

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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