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FRENCH BANKING FEDERATION RESPONSE TO THE BCBS 271 CONSULTATIVE DOCUMENT ON NSFR

The French Banking Federation (FBF) represents the interests of the banking industry in France. Its membership is composed of all credit institutions authorized as banks and doing business in France, i.e. more than 390 commercial, cooperative and mutual banks. FBF member banks have more than 38,000 permanent branches in France. They employ 370,000 people in France and around the world, and service 48 million customers.

The French Banking Federation appreciates the opportunity to comment on this revised proposition on the Basel III Net Stable Funding Ratio and welcomes the change to the definition from a 1 year long stress test to a structural liquidity risk metric. This new definition of the NSFR makes very much sense as it complements the Liquidity Coverage Ratio (LCR) which is based on an extremely severe liquidity stress scenario.

I. Introduction

Indeed, the liquidity maturity transformation is needed for the economy since there is a structural discrepancy between liquidity providers and liquidity takers. Hence, the NSFR should reflect the extent of the acceptable sustainable liquidity maturity transformation, and the sources of this maturity transformation. And the Available Stable Funding (AFS) and Required Stable Funding (RSF) factors have to be calibrated accordingly.

This being said, and despite the change in this new set of proposals, we think that NSFR will have a negative impact on short term activities. So firstly we ask the BCBS that NSFR rules take into account the huge regulatory changes that have been and are being implemented in the financial sector (LCR, Leverage ratio, new definition of capital etc.) that are intended to make the financial industry far more resilient to future shocks.

Secondly we urge the BCBS to take sufficient time to consider and factor in the data from the Quantitative Impact Study (QIS) for the final calibration of the NSFR that is expected early 2015, and we want to remind the BCBS that the overall NSFR capital shortfall is underestimated as NSFR will certainly be applied at solo level, in the EU notably. We think more quantitative impact analysis will be required before we can assess the appropriateness of the NSFR calibration.

Moreover we would welcome the BCBS to include in its draft accord text a provision allowing national supervisors to contemplate national or local specificities.

Finally the FBF expresses its support to others industry responses, especially from IIF, IBFed, and EBF.

Changes on calibration

The FBF reacts positively to the following changes:

- The RSF for assets that are not market-liquid such as longer than 1 year loans (85% RSF);
- The RSF for assets that are regularly sold or secured-funded thanks to their high credit quality (65% RSF);
In all of the above, we recommend to clarify that expected maturities are considered rather than contractual maturity, notably to take into account prepayment on loans that are expected in the 12 months.
- Retail deposits are considered stable funding sources with a higher ASF;
- The portion of non-retail deposits that are considered stable is increased;
We recommend however that operational deposits (custody, clearing, cash management) should be recognized with a higher ASF than other deposits.
- The introduction of a 0 to 6 month time band to avoid cliff effect.

The FBF reacts negatively to the points below:

- The market-liquidity of non-HQLA securities is not sufficiently recognized;
Non-HQLA Market liquid securities require as much RSF as loans, i.e. 85% RSF regardless of the maturity of the security.
- The treatment for financial counterparties is asymmetric for no reason consistent with the NSFR;
A loan granted to a non-bank-financial institution with a maturity of less than 6 months gets assigned a 50% RSF, while the same loan with a maturity of less than 6 months received from a non-bank financial institution gets an ASF of 0%
- There is no distinction between secured and unsecured lending/borrowing;
The above example applies to a less than 6 month reverse repo and a 6 month repo and leads to a requirement of stable funding for a position that is fully matched

The NSFR would have very detrimental consequences on market making activities (on sovereign debt notably). This is at odds with the necessity in Europe to strengthen market-based financing to substitute for bank-based financing that has been lowered by the regulatory environment.

- The assumption that debt are redeemed at the earliest possible date, even when redeeming is at the discretion of the bank, is inconsistent with a structural approach of the NSFR.

Relying on LCR parameters

While we recognize the simplicity of relying on LCR parameters, we believe that their use in the NSFR is inconsistent with a structural measure of liquidity not underpinned by a stress scenario. This is especially impactful for assets which are deemed to be non-HQLA under the LCR.

In setting RSF factors at similar levels as LCR haircuts for various liquid assets, due consideration was not given to:

- The different time horizons (12-month NSFR vs. 1-month LCR);
- The severity of the scenario under consideration (NSFR is not a stress metric while LCR is an acute stress test) even if there was a small concession for some Level 3 assets with 85% RSF factor (versus 100% illiquid in LCR), and the removal of the caps for Level 2 assets, which is of no current benefit on a consolidated basis in some jurisdictions;
- The linkages that exist between HQLAs and liabilities and/or derivatives transactions in many business strategies, taken together, materially reduce the net NSFR risk of these 'linked' transactions in a normal course of business.

II. Specific Issues

Asymmetrical treatment of financial counterparty

A loan granted to a non-bank-financial institution with a maturity of less than 6 months gets assigned a 50% RSF, while the same loan with a maturity of less than 6 months received from a non-bank financial institution gets an ASF of 0%. Hence, a perfectly match-term position is not NSFR-neutral, which is not consistent.

We draw the attention of the BCBS on the potential consequences of such measure on repo markets; this will have the same effect than a financial tax and will potentially cause huge damage on it.

Therefore we recommend that:

- symmetry applies including for transactions with financial institutions: RSF factor should be similar to ASF factor, i.e. 0% RSF for shorter than 6 months, 50% for longer than 6 months and shorter than 12 months, 100% beyond, at least for all regulated entities (insurers, asset managers, pension funds etc);
- secured lending/borrowing transactions are segregated from unsecured lending/borrowing transactions. Indeed, ignoring the securing assets lead to inconsistencies;
- short positions are netted out of the reverse repos they originate from (by ISIN).

Moreover, we point out to the BCBS on unintended consequences related to this asymmetrical treatment which will not only apply to short term matched-funding activities. For example, the 50% RSF will also apply to the deposits made to Central Counterparty Clearing House (CCP) if they are related to transactions with a maturity of less than 6 months. It does not seem consistent that these deposits systematically require stable funding, even when they have been made to secure short term transactions.

Derivatives

We welcome the BCBS is considering changes for dealing with derivatives, and we would like to offer the following insights on the treatments of derivatives positions and related cash collateral paid/received as initial and/or variation margins under the NSFR.

It is not clear, in our opinion, if the current approach has yet to be better defined with regard to the treatment of cash collateral paid/received as initial and/or variation margins, or whether these cash positions should be funded / invested on a long-term horizon. In the latter case, it should be noted that the market standards (based on the NPV/OIS discounting) consider these items as very short term positions consistently with the remuneration paid by the CCP.

We propose the following treatment of derivatives in successive steps.

- calculate the net derivatives payables and net derivatives receivables in accordance with ISDA agreements (or similar) where possible ;
- net from the above payables and receivables amounts respectively the collateral posted / received to the extent that they can be re-hypothecated by the bank ;
- calculate the net amount between residual derivatives payables and residual derivatives receivables from the amounts obtained above, to the extent of re-hypothecating right.

Apply a 100% RSF or 100% ASF factor to the residual value obtained from the last step.

Initial margins, when applicable, should recognize symmetrical ASF/RSF factors, depending on the maturity of the underlying transactions they relate to:

- 100% RSF/ASF -if re-hypothecable- or RSF for transactions with a maturity beyond 1 year or where maturity is not known ;
- 50% RSF/ASF for transactions with a maturity comprised between 6 months and 1 year ;
- 0% RSF/ASF for transactions with a maturity below 6 months or if the received initial margin is not re-hypothecable.

HQLA and non HQLA (see also appendix 1)

We recommend a wider definition of liquid assets for the NSFR to reflect market liquidity; market-liquid Assets could be defined as all securities that are actively traded on recognized markets.

- The maturity of securities, where applicable, should be considered: shorter than 6 months securities should receive a 0% RSF, assets whose residual maturity is between 6 and 12 months should be applied 50% of the RSF that applies to this asset category.

- RSF for market-liquid securities should be no greater than 25%, including for Level 2B assets with a carve-out for equities listed in major indexes that are held to cover derivative portfolios:

Equities that are held to hedge market risk exposures should be allocated the maturity of the underlying risk exposures which they hedge. By way of example, an asset that is held to hedge a derivative with less than 6 month maturity should be applied a 0% RSF. Where the derivative has a residual maturity of between 6 and 12 months, the corresponding hedging asset should have an RSF of 50% of the RSF of the asset; and for derivatives of greater than 12 months the asset would attract 100% RSF of the asset.

Impacts on other fields

Short term activities such as trade finance, factoring etc

We recommend to exclude some short term loans from the rollover assumption that relate to short term activities such as trade finance and factoring. Short term loans that relate to structural short term activities such as trade finance should be excluded from the 50% rollover assumption applying to the loans to non-bank financial institutions and non-financial corporates in order to avoid detrimental adaptations of activity.

Callable bond or debt

The assumption that debt are redeemed at the earliest possible date, even when redeeming is at the discretion of the bank, is inconsistent with a structural approach of the NSFR. Moreover, this rule is inapplicable: a bank cannot demonstrate that it will not exercise an option 'under any circumstances' and is in contradiction with the Basel treatment that applies in the LCR. As for considering expected prepayment on loans, we recommend that debt should be considered for their expected maturity.

Guaranteed loans

Clarifications are essential concerning the treatment in the NSFR of the residential loans secured by a guarantee. Indeed, these loans are of the same high credit quality as the residential mortgages so we ask the BCBS to contemplate that they can benefit from the same RSF (i.e. 65%).

Should this 65% RSF factor not recognized for these loans, the impact on the NSFR of the concerned banks will be significant, and will by the way introduce a level playing field issue.

Covered bonds

Covered bonds and more generally secured debt with a maturity less than 6 months should benefit from an ASF of at least 50%, and not 0%. Indeed, to be consistent with the definition of the NSFR as a structural liquidity metrics, there is no reason to anticipate that an institution will not be able to roll its secured debt issuances insofar as there is a roll-over assumption applying on the asset side to loans that can be used as collateral.

Others assets and other liabilities

Numerous balance sheet items are not explicitly mentioned in the NSFR and consequently are considered other assets with a 100% RSF and other liabilities with a 0% ASF, which makes the default treatment extremely penalizing for no valuable reason. Most probably, this is unintended by BCBS.

The FBF recommends that a principle is clearly articulated in the NSFR so that balance sheet items that fall in other assets and other liabilities categories are netted out, and tenorized in 0-6 month, 6-12 month and greater than 12 month time bucket.

As an illustration, accruals (such as the settlement accounts on securities for instance, but not only) on both assets and liabilities should be netted out before being applied the relevant RSF/ASF.

APPENDIX: Treatment of derivative transactions and their hedge

Issue: How to treat in the NSFR the liquidity value of an asset which hedges derivative exposures?

The current framework does not explain if a specific treatment can be applied to an asset that market risk is fully hedged. Currently a haircut would apply depending on the classification of the asset into the liquidity buffer (ex: 50% haircut for non-financial equities).

Our Proposal:

Equities that are held to hedge market risk exposures should be allocated the maturity of the underlying risk exposures which they hedge. By way of example, an asset that is held to hedge a derivative with less than 6 month maturity should be applied a 0% RSF. Where the derivative has a residual maturity of between 6 and 12 months, the corresponding hedging asset should have an RSF of 50% of the RSF of the asset; and for derivatives of greater than 12 months the asset would attract 100% RSF of the asset.

The description is the following:

Banks commonly act as market intermediaries to facilitate client trading strategies. There are derivative linked strategies where banks carry cash equity inventory to facilitate these strategies – but where the bank does not face any material market or funding risk, and where symmetrical unwind of the ‘package’ is assured through credit, liquidity, and market risk safeguards.

Equities held by banks are associated with these strategies. And there is a lack of consideration for these ‘packaged’ or linked transactions where both the asset and the liability are a part of a single structure.

Certain strategies should be linked and treated on a ‘packaged’ basis; including:

- TRS/Equity Swaps vs Cash Equity
- Futures vs Cash Hedge...

The linkage between equities and their hedge ensures simultaneous unwind/exit at maturity of the derivative. Markets structures allow for simultaneous unwind of the cash equity along with the expiry of the derivative with full pass-through of market and funding risks to the derivative counterpart. Risk limit constructs ensure that banks cannot partially unwind linked structures. It is not difficult for banks to demonstrate linkage through their risk management systems on a daily basis. Linkage has the effect of aligning the tenor of the equity to the maturity of the derivatives, which is typically short term.

The linked structure provides cash equity funding price risk protection in the form of variation margin from equal and offsetting changes in value of the associated derivative.

Example 1– Equity Swaps (TRS)

- To facilitate a client’s trading strategy, the bank goes long the security as a hedge to a total return swap written to the client. The equity hedge is financed in the secured funding market
- The equity swap is documented under and ISDA which makes specific reference to the cash equity
- Price risk of the cash equity hedge is mitigated because the client is required to post variation margin. Variation margin mitigates the risk that the value of the hedge in the secured funding market will change through price depreciation
- On expiry of the swap, the equity hedge is liquidated. The market price on the liquidation is fully passed through to the client
- Equity swaps are short term instruments, most including puts that can be exercised by banks daily, weekly or monthly

Example 2: Futures market making involves hedging exposure in the futures market with cash securities. The cash security hedge is sold at the expiry of the future – which happens every 90 days (90 days is the longest time to maturity of the ‘linked package’). Established market structure mitigates all liquidity and market risk on the expiry. This is because the cash hedges are sold by participant in a special ‘market on open order’. The weighted average price of the market on open order is used to set the closing price for the future.