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2016.06.24

FBF RESPONSE TO EUROPEAN COMMISSION'S CONSULTATION PAPER ON FURTHER CONSIDERATIONS FOR THE IMPLEMENTATION OF THE NSFR IN THE EU

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 FBF welcomes the opportunity given by the Commission for the industry to share its view on the potential impact of the forthcoming NSFR implementation in the EU. The FBF particularly welcomes that the Commission highlighted in its Consultative Document specific areas of concerns, which were also identified by the industry. We have appreciated the fact that the Commission will not be making any hasty decisions on NSFR, and will carry out thorough preparatory work for the NSFR implementation upon basis of the EBA report and stakeholders' analysis.

As already noticed in our letter to Mario Nava dated 2016 March 1st, the FBF welcomes the EBA recommendations regarding certain national specificities (e.g. regulated savings, covered bonds issuers, and residential guaranteed loans) and reiterates its support for the Commission to take into account these recommendations in its legislative proposal.

Conversely, the FBF is particularly concerned on the potential impact on market activities, especially short-term markets, which could jeopardize the ability of banks to provide market making services, hedging derivatives, and repos, due to inappropriate calibration of Required Stable Funding factors (RSF) decided by the Basel Committee. Moreover, even if the EBA recognizes that trade finance products facilitate the trade of goods and proposes a differentiated treatment for this activity, the EBA proposal is still penalising. It will notably impact European exporting SMEs, who rely on banks for supporting them internationally.

These specific issues are particularly commented in our detailed response that you will find hereafter, and that we are pleased to share with you. We are looking forward to on-going constructive dialogue with the European Commission and we are at your disposal should you need any further input.

1. In light of previous consultations, could you describe more specifically, if appropriate, the specific activities, transactions and business models where you have evidence that the implementation of the NSFR could have an excessive impact or important unintended consequences?

a. **The NSFR will have a massive impact on market activities and short term transactions (including trade finance)**

In a nutshell:

- The punitive treatment of HQLA Level 1 securities will also be detrimental to the liquidity of markets. Indeed there is an element of circularity as those level 1 assets are precisely held to match liquidity requirements. The liquidity buffer should not generate additional liquidity needs.
- The asymmetrical treatment of short term transactions with financial counterparties such matched books (repos/reverse repos) or interbank markets which are a key driver of liquidity, will also create liquidity issues and will make it more difficult for banks to provide market making services to issuers and investors.
- Regarding derivatives, the leverage ratio netting criteria, the asymmetrical treatment of securities collateral, the non-recognition of Initial Margins received that can be re-used, and the 20% RSF add-on on gross derivative liabilities will be very detrimental for the industry and end users.
- The treatment of Trade Finance would lead to a more penalizing treatment than for other activities, even though this activity is recognized as short term by the EBA, and the Delegated Act on Liquidity Coverage Ratio (LCR) adopted a preferential treatment for those activities. The Commission should go beyond the EBA proposal which remains too conservative.

Due to the current calibration on capital market balance-sheet items, NSFR massively overstates actual one-year liquidity gap: as a consequence, **providing market making services will become extremely expensive**, particularly on government bonds and equities; additional funding costs that will be incurred for NSFR compliance will largely exceed the low margin generated by of these activities. For example, on sovereign bonds market making, estimates sets the additional regulatory cost due to LCR/NSFR and leverage ratio between +60bp to +110 bp, compared to a +5bp bid/ask spread.

Banks will have then only 2 solutions (i) either to increase massively the price to be applied to customers, or (ii) to stop the activity. As economic theory tells us, significant price increases are bound to reduce overall volume of market making and thus market liquidity. It is highly unlikely that retrenchment by large European investment banks may be compensated by other players (for instance European smaller banks), as capital market activities have significant entry costs, in terms of investments, skilled staff, inventories size and critical mass, against a backdrop where Europe's investment banks are already losing ground compared to their US peers.

The impact on derivative markets is also massive, as the whole NSFR treatment of derivatives (including the 20% RSF on derivatives liabilities) does not adequately reflect true funding risks over a 12-months horizon. In addition to **removing the inadequate reference to leverage ratio criteria for netting and cash variation margin recognition**, we would also like to stress the importance of a better recognition of securities collateral. Indeed, **it does not make sense to disallow derivatives netting with HQLA securities collateral** in the NSFR calculation, whereas the LCR specifically recognizes their liquidity value under stress up to a regulatory defined haircut on MtM value.

The NSFR being a structural ratio, not a stressed ratio, should have rules that are more favorable, not less than the LCR. One consequence of this will be a reduction of the liquidity of these securities held as collateral; based on the new rules; banks would be disincentivized to use them, neither as collateral for OTC derivatives nor for listed/cleared derivatives markets.

b. <u>Long term funding with covered bonds will be curbed</u>

Covered bonds are at the heart of the European financial tradition, playing an important role in funding strategies and proving to be a cost-effective and reliable long-term funding debt instrument, characterised by key safety features, including a strict legal and supervisory framework, asset segregation and an actively managed cover pool. They played a pivotal role in bank wholesale funding during the recent financial turmoil as one of the only asset classes able to restore investor confidence and ensure access to debt capital markets for European issuers. Furthermore, Covered bond companies are often required to be set up as separate legal entities and they are not allowed to take deposits from clients.
In the Basel definition of NSFR, mortgage loans funded by covered bonds are regarded as encumbered and receive a higher RSF weight compared to mortgage loans funded by e.g. shorter term senior bonds. This treatment sends a negative signal to the covered bonds issuers and invites credit institutions to reduce their volume of covered bonds issues and increase their volume of short term senior bonds.

It would be necessary to align the weightings of encumbered assets in the cover pool to the weightings of unencumbered assets. We would appreciate confirmation that, **where the covered bonds assets (loans) and liabilities (bonds) have coherent maturities and are subject to regulatory requirement they are not submitted to unfavorable weightings** as mentioned by the EBA on its report on Net Stable Funding Requirements (EBA/Op/2015/22) published on December 2015, 15th :

- The RSF factor for operations with a maturity of more than 12 months should be similar to the underlying unencumbered loans[1]. Those assets are inequitably considered as encumbered and require 100% RSF for maturities >1 year. In fact**, assets included within the cover pool could be mobilized** to reimburse covered bonds holders within a secured framework that limits maturity transformation.
- **When legal framework prohibits covered bonds issuers to post collaterals[2]**. This requirement will make covered bonds particularly sensitive to the add-on however **the negative marked-to-market positions of the derivatives will not have to be funded**. It seems inconsistent and unfair to apply the 20% RSF add-on to credit institutions exempted posting collateral.
- **The asymmetry between ASF and RSF <6 months operations is economically excessive for secured funding issued by covered bonds**. The treatment of covered bonds with a residual maturity below 6 months does not take into account covered bonds issuers true funding profile. All short term capital market funding is treated as unstable funding, while during the financial crisis, covered bonds' funding capacities were more stable than unsecured wholesale funding. Covered bonds cannot be generally drawn by investors on a daily basis (no redeem options),

[1] This subject was mentioned by Director Nava in its August 3rd, 2015 response to an FBF letter.
[2] For example, French law n°L515-19 of the *Code Monétaire et Financier* exempts covered bonds vehicle from posting variation and initial margins.

assets and liabilities duration are aligned and supervised, and no acceleration of payment can occur especially in case of sudden or severe deterioration in the liquidity environment.

c. <u>Impacts and costs of compliance with NSFR should not be underestimated</u>

Finally according to the EBA, the shortfall of non-compliant banks in this sample in June 2015 amounts to EUR 341 billion (vs EUR 595 billion in December 2014). The FBF believes that this shortfall is underestimated for a variety of reasons:

- EBA did not take into account the fact that NSFR could be applied at solo level in the EU, unless waiver requirements are substantially eased. It is very clear that for a given banking group, the sum of solo NSFR requirements will largely exceed to NSFR need at consolidated level. The FBF reiterates the major importance, both financially and politically, of making possible the free flow of liquidity within the EU and a fortiori the Eurozone, in the context of the goal of Strengthening the Banking Union.
- EBA did not provide any analysis of the elasticity and depth of the long term debt market or retail deposits in Europe in order to cover the NSFR shortfall. EBA analysis did not take account on one hand that debt primary markets could be simultaneously overloaded due to TLAC/MREL future constraints.
- Banks liquidity position is currently improved by the current unconventional monetary policy measures. **TLTRO funding amounts to EUR 400 Bn**, which considerably helps the compliance to NSFR. This amount will have to be funded in the market once the ECB normalizes its policy.

2. If a respondent is a bank, could you please quantify the level of your expected shortfall of stable funding, the changes to the composition of your balance sheet that may result from meeting the NSFR and what the impact of these changes may be on the European economy?

FBF members will respond individually to this part of the questionnaire.

3. In light of previous consultations, could you provide substantiated evidence about possible issues caused by the application of the BCBS NSFR standard to derivative transactions at European level and which have not been taken into account at Basel level? If yes, what alternative treatment would you propose for NSFR calculation purposes to deal with the funding needs arising from derivatives transactions? If possible, please provide the impact on your institution of the alternative treatment you propose (as compared to the BCBS standards).

There are 5 majors issues related to the derivatives treatment under NSFR:

- The inadequate reference to leverage ratio criteria (disallowance of netting between assets and liabilities and recognition of cash variation margin received);
- The non-recognition of non-cash collateral received to net derivative assets exposures;
- the non-recognition of reusable initial margin received as an offset to initial margin posted ;
- The 100% RSF on net derivative assets vs the 0% ASF on net derivatives liabilities irrespective of their maturity;
- The additional RSF of 20% on gross derivatives liabilities (See Question 4).

The asymmetrical treatment of collateral will be particularly detrimental:

Reference to the leverage ratio criteria for the recognition of cash variation margin received should be removed as they are irrelevant in a funding context. A single euro of under collateralisation may mean that the full amount of cash received is disregarded in the NSFR calculation whereas it represents real funding for the bank.

Only a portion of margins received in the form of cash can be deducted from the derivative asset exposures. This deductible portion is defined by BCBS with reference to the BCBS Leverage Ratio rules, involving for instance that only cash collateral can be deducted which is exchanged on a daily basis, in the same currency as the underlying derivatives, etc... These restrictions designed to compute a leverage exposure are not relevant for liquidity measuring purposes. For instance, many master agreements involve weekly margin calls, in order to handle the operational constraints of non-financial counterparties. We cannot see how a weekly margining would weaken the financing capacity of the cash received as compared to a daily margining. **We thus recommend that all the cash received as collateral be deducted from derivative asset exposures, whatever the rules of the Leverage Ratio.**

Margins received in the form of High Quality Liquid Assets (HQLA), though recognized as highly liquid in extremely adverse market conditions in the Liquidity Coverage Ratio (LCR), are not considered as offsetting the liquidity requirement from derivative assets exposure in the NSFR which is supposed to be a structural, non-stressed, liquidity metric.

Conversely, posted collateral margins are all considered as equivalent whatever the type of collateral, being in form of cash, or in form of HQLA. Hence, a HQLA bond received from a collateral agreement, posted in another collateral agreement would lead to a long term funding requirement.

Any asymmetrical treatment of collateral would lead to an increase need of cash and a decrease, or discontinuation, in the usage of bonds as collateral, both of which would be detrimental to the market liquidity of bonds (which will translate into higher coupons) and increase the cash needs for the industry to operate.

Finally, initial margin received that can be reused is not allowed in the BCBS NSFR to offset the 85% for initial margin posted. This is inconsistent with the actual funding requirements and will be highly detrimental for derivatives intermediation, in particular for banks providing derivatives clearing services to clients. This is especially unfortunate in the new EMIR environment where derivatives clearing becomes mandatory and will increase the cost of derivative usage for end users as clearing banks will need to transfer the additional funding cost. Indeed, while OTC derivatives IM is non-rehypothecable under EMIR, for cleared derivatives intermediation, collateral received from clients by the clearing bank should provide natural funding to offset the RSF requirement for IM posted for clients’ trades.

We therefore propose that collateral received or posted should be treated symmetrically, at the very least for HQLA:

- Reference to leverage ratio criteria for cash variation margin received should be removed ;
- Rehypothecable HQLA collateral received as collateral margins should be considered as an effective and relevant liquidity risk mitigant;
- Reusable initial margin received should be allowed to offset initial margin posted before application of the 85% RSF.

4. More specifically, regarding the 20% RSF factor applicable to gross derivatives liabilities, do you think it would be possible and appropriate to develop a more risk-sensitive approach that would take better account of the funding risk arising from banks' derivative activities over a one-year horizon? In that case, what could be this approach? Do you think that the use of the SA-CRR could provide an appropriate measure? If possible, please provide the impact on your institution of the alternative treatment you propose (as compared to the BCBS standards).

As mentioned earlier, we question the logic of this 20% RSF factor in the context of a structural, non-stressed liquidity metric. This provision adds an extra overlay of funding requirements, over a NSFR derivative asset calculation that is already very conservative.

Banks are already required in LCR to maintain a liquid asset buffer large enough to cover 100% of stressed collateral outflows over a 30 days period. It is therefore absurd to further require them to fund on a long term basis hypothetical collateral requirements, thus diverting permanently liquidity from the funding of the real economy.

Accordingly we recommend the 20% RSF factor should be removed from the European implementation of the NSFR.

We understand that there could be a concern that the RSF for derivatives may be nil in specific circumstances where derivatives liabilities are higher than derivatives assets – although this is a very remote scenario given the calculation asymmetries in the BCBS standard as detailed above. In our view, this is not an issue, as derivatives liabilities do not generate funding requirements.

Also, the assumption that 85% of the initial margins should be funded at more than one year, while most of the derivatives are either short term or frequently sold or unwound within less than one year, is also conservative.

However, to alleviate this concern, **this could be addressed by transforming the 20% RSF additional requirement into a floor to be applied to the sum of the two other requirements related to derivatives.**

The RSF requirements for derivatives would therefore be the maximum of:

- 100% RSF of NSFR derivative asset + 85% of (net) Initial Margin posted and;
- 20% RSF of NSFR derivatives liabilities.

This would ensure that an amount of stable funding would always be available for derivatives, although the logic of such requirement would remain flimsy.

If the Commission were to maintain some add-on for potential derivatives market movements, a less damaging alternative would be to develop an Historical Look back Approach, similar to the one used in the LCR framework. In that respect the FBF is open to discuss further with the Commission how to develop such an approach.

Finally to answer more specifically the consultation's questions, we would note the following points:

The consultation mentions that this RSF would aim at capturing "to some extent, future funding risks arising from negative mark-to-market movements that ultimately result in net requirements to post collateral." As the Consultation Paper correctly points out, the major flaw of the 20% add-on on derivative liabilities is that it does not take into account the situation where offsetting derivative positions on the asset and liability sides can lead to a low risk sensitivity of the derivatives portfolio to those potential adverse market movements.

We do not consider that the use of the SA-CCR would be a good alternative solution to the current BCBS 20% RSF factor applicable to gross derivative liabilities:

First, SA-CCR is not yet transposed in EU regulation, and as such it would be odd to use it as a basis for an EU implementation of the NSFR.

More fundamentally, when used to calculate counterparty credit risk, SA-CCR is calculated at the counterparty level. Such a counterparty by counterparty approach would have no rationale when it comes to NSFR as it would allow no funding compensation between offsetting derivative positions with different counterparts. For instance, a collateralised interest rate derivative with a given counterparty may be market-risk hedged with another matching collateralised derivative with another financial institution. In practice, collateral requirements on both derivatives will offset, resulting in eliminating potential volatility in funding requirements. Using the SA-CCR would ignore this offset and require an additional stable funding requirement for both derivative legs, which makes no sense. The only rational use of the SA-CCR would be to calculate this metric on a fully netted basis across all counterparties, as if all counterparties were a single one. This would provide a correct estimate of the potential volatility of funding requirements.

However, proceeding this way would remove the main benefit of this approach – the reuse of existing calculations, as the 'fully netted' SA-CCR described above would require a calculation engine specific to the NSFR.

5. If you propose special treatment for specific activities (eg hedging instruments, clients clearing…), how would you define these activities?

The FBF believes that the section of the NSFR on derivatives should cover the situation of securities hedging derivatives.

Indeed, market making on liquid listed securities and on derivatives on these securities is an activity with high volumes and low margins. In particular, it requires significant inventories of these various instruments. As most of our equities inventory are used as hedges of derivatives instruments, those hedges will be disposed of at the earliest of the maturity of the derivative or the prior sale thereof. It is therefore conservative to assume that these securities will be kept until the former, the maturity of the derivative.

Unfortunately under the BCBS NSFR proposal, the maturity of derivatives is disregarded. A net derivative asset is fine assumed to have a maturity beyond one year, which does not make sense as most of our equity derivatives instruments have short term maturities, well below one year.

We therefore suggest adjusting the Required Stable Funding (RSF) factors of listed equities when they hedge derivatives. More precisely, when the bank, within its trading book, holds an equity instrument to hedge a derivative instrument, and can indisputably establish the hedging relationship between both, then the RSF factor of such equity instrument should be adjusted to the maturity of the derivative. For this purpose, we propose to use the three maturity adjustment buckets usually used in the BCBS NSFR proposal, and to multiply such maturity adjustment by the RSF factor that would apply to the security, as illustrated in this table:

Remaining contractual maturity of derivative	**Adjustment**	Level 1 security hedge RSF factor	Level 2a security hedge RSF factor	Level 2b security hedge RSF factor	Non-HQLA security hedge RSF factor
0-6 months	15%	0.75%	2.25%	7.5%	12.75%
6-12 months	50%	2.5%	7.5%	25%	42.5%
12 months +	100%	5%	15%	50%	85%

For instance, a non HQLA equity hedging a derivative with an 8 month maturity would require 50% x 85% = 42,5% stable funding.

6. In light of previous consultations, could you provide substantiated evidence about possible issues caused by the application of the BCBS NSFR standard to short term transactions with financial institutions at European level and which have not been taken into account at Basel level? If yes, what alternative treatment would you propose for NSFR calculation purposes to deal with the funding needs arising from short-term transactions with financial institutions? If possible, please provide the impact on your institution of the alternative treatment you propose (as compared to the BCBS standards).

The BCBS NSFR standard treats in an asymmetric way short term transactions with financial institutions with a 10% stable funding requirement for transaction backed by Level 1 collateral, 15% otherwise, while short term funding has no ASF value.

The requirement that 10% or 15% of reverse repos shorter than 6 months should be long term funded is a fatal flaw:

- This introduces an asymmetrical treatment between assets and liabilities. Hence, a fully matched book repo (i.e. reverse repo offset by a repo with exactly the same characteristics) would require long term funding for no reason.
- These activities are short term (< 6 months) whereas the NSFR aims to ensure liquidity structural stability in a long term horizon (over 1 year).
- Such NSFR would be detrimental to market making activities and Capital Market Union.

- The underlying assumption that the bank would be forced to roll part of these instruments in order to meet its counterparty's expectations is not substantiated: in most instances, financial counterparties are active participants in the concerned market, they deal with several counterparties at any time, and can easily resort to another one in case the bank decides not to roll a trade. This is true in particular for the regulated entities, and for all secured trades where at maturity, the counterparty of the bank recovers its securities in exchange of the cash and can refinance them elsewhere.

This has major consequences for two activities:

- Market making in securities due to the increased funding cost for matched repos / reverse repos transactions
- Short term interbank transactions

<u>Market making</u>

Market marking relies on short term repos and reverse repos to fund the market maker's inventory and cover short positions resulting from transactions with clients.

The scope of the asymmetric treatment of repos/reverse repos < 6 months with financial counterparties was enlarged in the final BCBS standard to non-banks, including regulated financial institutions such as insurers, pension funds and asset managers which hold securities, which will disincentive banks to enter into reverse repos with them, limiting the banks responsiveness to meet buy orders from investors.

The remaining asymmetry will be detrimental for the market making of securities. As the long term funding available for banks is scarce and costly, banks will have no other choice than to dramatically downsize their very low profit market making activities and to require higher bid/ ask spreads. This would run contrary to the stated objective of the Commission to develop European Capital markets and market based funding for European corporates.

In particular, the remaining asymmetry will be detrimental for the market making of **government bonds, which represent roughly 80% of the underlying assets for repos and reverse repos.**

<u>Short term interbank transactions</u>

Unsecured short term lending to other banks would require a 15 % RSF. The symmetric treatment of repos/reverse repos < 6 months with supervised Banks has been removed in the final BCBS standard and replaced by the same asymmetric treatment with non-financial counterparties (10% if L1 or 15% otherwise)

This will hurt the already very weak interbank market and would be an issue for the reliability of interbank interest rates benchmarks such as EURIBOR.

Reverse repo and short term lending transactions with financial institutions should be treated symmetrically to repos or borrowings, with a 0% RSF for shorter than 6 month maturities. Fundamentally, we do not see the rationale of having to raise funding with more than 1-year maturity, to finance transactions of less than 6 months, collateralized with HQLA assets (High Quality Liquid Assets).

7. If you propose special treatment for specific activities (e.g. client's short facilitations activities, prime brokerage businesses…), how would you define these activities?

We understand that the rationale behind the asymmetrical treatment of such transactions was a US regulators' concern to reduce banks' funding to shadow banking entities (hedge funds notably) that may, in crisis, amplify financial stress by engaging in 'fire sale' of financial assets if they are unable to roll-over their secured funding. However we note that the role and size of shadow banking is much bigger in the US than in Europe where a much larger share of the financing of the economy is intermediated by banks. We would also emphasize that regulated financial institutions such as banks, investment firms, CCPs, insurance, pension funds and UCIT mutual funds are much less likely to suffer from a funding strain in a crisis than unregulated financial entities (such as hedge funds).

As a last resort, if our proposal in Q6 is not achievable, we propose to reintroduce a distinction between regulated financial entities and others in the NSFR treatment of short term transactions with financial institutions, whereby there would be no asymmetry for the former, while the current BCBS treatment would remain for the latter.

This would also be consistent with the European LCR which allows for a more favourable treatment of credit facilities to such regulated entities (Delegated Act article 31-8).

8. What do you believe the appropriate level of application of the NSFR to be? Is there scope to make the NSFR requirements more proportionate and, if so, on the basis of what criteria?

On the level of application:

We reiterate our recommendation of an application of the NSFR on a consolidated basis only. Indeed, BCBS has designed the NSFR's calibration on a consolidated basis, taking into account the diversification of the banking activities (balance between retail businesses, capital market activities, and short term specialized business models such as factoring or trade finance).

An EU transposition of the NSFR on a standalone basis would be contrary to the initial intention of the BCBS. Consequently, it should not be considered without a precise quantitative impact study taking into account the diversified organizations of banking groups in the EU. In particular, it would certainly penalize, in terms of level playing field, banking groups which have organized their capital market activities and/or their trade finance/factoring activities within subsidiaries. These groups would not be able to benefit from any diversification effects, contrary to groups which have organized these activities within only one operating legal entity. It would also penalize cross border banking groups, although those groups should be allowed to play an important role in the integration of the European financial system.

Should the NSFR be applied at solo level, preferential treatments should be introduced to deal with intragroup transactions. These adjustments should be automatically granted by law, and should not be subject to any competent authority's authorization. Indeed, the process and requirements to obtain cross-border waivers under article 8 of CRR, or exemption of the cap of intragroup inflows under art 33 of LCR Delegated act is very burdensome. At least for intragroup transactions within Banking Union area, a symmetrical treatment should be introduced in the level 1 text, whereby ASF for the borrowing entity would be equal to the RSF for the providing entity.

Indeed, as explained in the FBF's letter to EBA's report sent to the Commission, managing NSFR at entity level within Eurozone is not consistent with the European treaty of free circulation of capital ("As a rule, there should be no restriction to the free movement of capital within the European Union. Under Article 63 of the Treaty on the Functioning of the European Union ("TFEU"), all restrictions on the movement of capital and payments between Member States shall be prohibited" *(extract from European Commission report 5thJune2014)").*

<u>*On proportionality:*</u>

As stressed in the EBA report, there is not enough evidence smaller banks had more balanced stable funding than larger entities. Therefore we strongly argue that NSFR requirement could not be a case for proportionality neither on size nor on business activities criteria. Reducing further the level of liquidity requirements for small banks for instance would lead to financial stability issues which would be in total contradiction to the EC goal to achieve risk moral hazard reduction in the context of EDIS.

Proportionality should exclusively apply to compliance burden (i.e. reporting and disclosure requirements), and it should apply both for independent small banks as well as for small entities belonging to a larger banking group, We recommend the frequency of calculation and reporting to be lower for these entities (i.e. annually and not quarterly). The condition of application of this preferential treatment should be in relation to the notion of materiality (to be determined).

We also note that the NSFR should be less binding for small and medium retail banks, given that they are (and should continue to be) less involved in Capital Markets businesses. Hence we do not see the need for further reduction of stable funding requirement for smaller banks.

9. In particular, what criteria could be used to define institutions with a "low liquidity risk profile"? What simplified metrics (e.g. core funding ratio close to loans to deposits + capital) could be used to identify these institutions? Should certain institutions be completely exempted from the NSFR and on what basis?

Were the NSFR requirement be met at entity level, Covered bonds issuing entities should be exempted from it. There is no funding risk on such activity, and implementing an NSFR requirement would lead to a decrease of their profitability for non-economic reasons.

We consider that the European NSFR should reflect the importance and the economic stability and avoid any disincentive to the covered bonds industry. The most efficient means to achieve this would be **to exempt covered bonds issuers of the European NSFR submission**. The NSFR weightings are not adapted to the pass-through business model of covered bonds. Besides, this business model is already submitted to a specific supervision. The whole balance sheet and off-balance sheet of covered bonds issuers listed in article 52.4 of the European Directive 2009/65/CE should be exempted of NSFR. This action will allow the NSFR to be consistent with article 425.1 of the European Regulation 575/2013 in which LCR inflows of eligible bonds are exempted from the 75% cap on inflows. This exemption at a solo basis should be associated to a **neutral integration as a pass-through business model when covered bonds issuers are integrated in the NSFR ratio of a consolidated Group**.

If the Commission were to maintain the NSFR requirement at entity level, in order to appropriately consider the specificities of covered bond funding and the reliability of this instrument, **we support that a specific exemption should be granted to Covered Bonds issuing entities.**
EC should take into account the pass-through specificities and constraints of covered bonds issuers as envisaged in the BCBS 295, article 45.

To conclude, with the current Basel calibration of the NSFR, a banking group will have to increase its volume of unsecured senior bonds while reducing its volume of secured covered bonds to reach its NSFR ratio. This need will generate an increase of the average funding cost of credit institutions which will inevitably be transferred in the cost of funding of mortgage loans distributed to retail customers. **The NSFR will have a negative effect on the financing structure of credit institutions and on the growth of the European economy**. In order to avoid such improper incentives for credit institutions issuing covered bonds, **the analysis should consider the overcollateralization level and composition:** the compulsory overcollateralization (legal/committed) may be considered as encumbered, but the voluntary component of the overcollateralization is clearly to be treated as unencumbered. In this context, the EBA final draft implementing technical standard (ITS) on asset encumbrance (EBA/ITS/2013/04/rev1) published on July 2014, 24th highlighted that the « *Instructions have been revised and clarifications have been made […] to further clarify that […] freely available O/C in cover pools that is not necessary to fulfil regulatory requirements would not be deemed to be encumbered […]* ». **Any difference of treatment of the over collateralisation between the NSFR ratio and the AER ratio would make the investor communication on covered bonds business model less clear.**