The voice of banking
& financial services

**BBA response to BCBS 271: Basel III: The Net Stable Funding Ratio**

Introduction

The British Bankers' Association ("BBA") is the leading association for UK banking and financial services for the UK banking and financial services sector, speaking for over 220 banking members from 60 countries on the full range of the UK and international banking issues. All the major banking players in the UK are members of our association as are the large international EU banks, the US banks operating in the UK and financial entities from around the world. The integrated nature of banking means that our members are engaged in activities ranging widely across the financial spectrum encompassing services and products as diverse as primary and secondary securities trading, insurance, investment banking and wealth management, as well as deposit taking and other conventional forms of banking

The BBA is pleased to respond to this consultation on the net stable funding ratio. Please find below are comments on the key issues in the paper.

## Objectives of the NSFR

The NSFR will require banks to maintain a stable funding profile in relation to the composition of their assets and off-balance sheet activities. We are very pleased that the NSFR is no longer described to be a firm specific stress test. However we believe that the calibration of some products (ASF and RSF), as outlined below, is more reflective of a severe stress than normal course scenario. This should be rectified to ensure firms are relying on appropriate and sustainable sources of stable funding over a long term horizon to be able to continually operate as going concerns, which is what the NSFR should be calibrated to do.

Consideration needs to be given to the impact of the proposed NSFR on funding costs, which will be mostly or fully passed on to bank clients. Increased funding costs impact the industry's ability to make markets, trade and hedge risk, support new issuance, and may end up increasing some costs to end users (if members could provide examples it may be useful here – without these examples the point will not be worth making).

Increased costs will be both direct (i.e., funding) and indirect (e.g., leverage). To meet minimum LCR requirements in an efficient manner from a leverage perspective, minimum funding tenors for assets (e.g., HQLAs) typically need to be in the 6 month to 1 year tenors. For NSFR, this is at least 3 years as, for example, 2 year tenors are only fully effective for 1 year, after which they lose part or all of their ASF value. The funding costs will vary

depending on each bank's funding curve. There is plenty of independent data available on the difference in funding costs between different tenors and firms.

Availability of longer funding tenors also needs to be considered. Generally speaking, the amount of term funding available to be raised in longer tenors is scarcer than in shorter tenor, more so for lesser than well rated firms. To the extent that costs become prohibitive or that scarcity becomes a material issue, there will be direct impacts on availability of banking products to clients. A calibration that is too focused on prudence and not enough on growth would have unwanted consequences for the broader economy.

**Definition of encumbered**

There needs to be a consistent definition of what is an encumbered and unencumbered asset across regulators and jurisdictions. This will be important for ensuring consistency and a level global playing field. We recommend the adoption of the definitions for liquidity follows those set out in paragraph 31 of Basel III: Liquidity Coverage Ratio and liquidity monitoring tools, January 2013.

**Derivatives**

We are very concerned that derivatives reporting in this context is by its nature very complex. The level of work that would arise from the current proposals is very onerous, and it would lead to institutions undertaking a disproportionately high level of work to achieve information required. We do not believe that derivatives reporting is the most important aspect of the NSFR reporting, but the granularity and difficulty surrounding the current framework could lead to it receiving a disproportionately high level of time and resource from firms.

Based on this, we would advocate an approach to derivatives that is as simple as possible and yet not overly onerous on its impact on funding requirements... The derivatives calculation should be undertaken on a portfolio basis to reflect a) the netting of derivatives where ISDA agreements (or similar) are held and b) the variation margin paid or received and then c) finally deducting resulting derivatives assets values from derivatives liabilities values to arrive at a single resultant asset or liability amount which should be given a RSF or ASF or the same value to avoid an asymmetrical approach. We would also recommend that this issue is examined in more detail in the years leading up to 2018, with the priority being given to other parts of NSFR that are more important to the calibration of the ratio.

**Reverse repos**

Repo and reverse repo with non-bank financials: A short-term repo transaction would attract a 0% ASF factor for the repo leg of the transaction and assuming the other counterparty is a bank then a 0% RSF weighting for the reverse repo element. However, if the counterparty to the reverse repo was a non-bank financial, then a 50% RSF would be applied for the cash leg (as a "Loan to non-bank financial institutions"). This creates an asymmetric treatment of repos compared to reverse repos with non-bank financials. The proposal does not differentiate between collateral types/quality (e.g. HQLA), which seems at odds with the general Basel framework and Liquidity Coverage Ratio in particular.

For example, in a reverse repo transaction where the bank lends cash and receives US Treasuries as collateral, there would be 50% RSF for the cash leg. There should be no difference in the NSFR risk profile for repos and reverse repos with non-bank financials, and we would therefore recommend a 50% ASF for repos with non-bank financial or a 0% RSF for the asset. Repos and reverse repos are a key funding tool for primary dealers in government securities. These desks use reverse repos on a daily basis to cover short inventory positions (restricted due to SSR). Application of a 50% RSF factor would materially increase the cost of funding for these desks and would limit their ability to act as primary dealers / market makers

Furthermore, Qualifying Central Clearing Counterparties could be categorised as non-bank financial institutions under the proposal (as they would presumably not fall into the category of "banks subject to prudential regulation"), meaning banks would have to assign a 50% RSF to centrally cleared reverse repos. If these exposures were left as nucleated inter-dealer transactions there would be a 0% RSF, resulting in a disincentive for banks to clear secured financing transactions.

The CP does not acknowledge the fact that the collateral received form reverse repos can potentially be used in other transactions. This unequal approach to repos and reverse repos will have negative impact on the transfer of secured funding between banks. On a wider scale, this has the potential to impact how secured financing is used in the real economy, which in turn could have its own negative impacts.

**Contractually linked transactions**

Certain interlinked securities, like Total Return Swaps (TRS) offer economically similar alternatives to short-term repos, but are treated inconsistently in the proposed rules. The hedges of TRS attract a RSF independent of the related derivative regardless of the fact that both asset and liability side of the trade will unwind simultaneously.
The NSFR should recognise the TRS and associated hedge as a SFT relationship due to the fact that trades are terminable by client/broker on short notice, and there is a risk of loss to asset value is offset by initial margin and price volatility is offset by variation margin. We recommend that there is an offset for initial margin linked with equity hedge position via attribution of ASF benefit to the Initial Margin.

**ASF factor for Operational Account Balances**

We welcome the recognition of Operational Deposits for NSFR as a positive development, which is consistent with the objectives of the revised NSFR. However, we remain concerned that the current ASF does not adequately reflect the stability of these deposits and risk undermining the standard by setting incentives for banks that are inconsistent with the stability principles of Paragraph 12.

Moreover, the Principles for Sound Liquidity Risk Management outline the goal of recognizing and incentivizing more-stable and resilient sources of deposits, which suggests that there should be further differentiation among wholesale deposits, reflecting actual experience, as for retail and SME deposits. This will help build incentives for banks to seek out stable sources of funding within wholesale markets, and reduce incentives to gross up the balance sheet with other less stable sources of funding which would also negatively impact the progress of banks with Leverage ratio requirements.

The definition of operational accounts outlined in LCR, which is also used for NSFR, required banks to only report balances from cash, clearing, and custody management where customers have a substantive dependency with the bank, and to strip out on a conservative basis any balances which are in excess of these requirements. The remaining core operational balance would display much higher stability in BAU and stress than a regular non-operational balance. If stress conditions were extended to up to a year it would be possible for funds to withdrawn, however we must remember that the NSFR is looking at the BAU funding profile of a bank. In these conditions the core stable balance is more likely to remain due to the substantive dependency of the customer on the bank and the depth of relationship.

We recognise that there are supervisory concerns about the consistent application of operational methodologies by banks. We welcome supervisory interaction to ensure a consistent definition and level playing field for banks for determining operational accounts, particularly as this issue has a large impact for LCR numbers due to become a binding requirement from January 2015. Industry practice generally compares transaction volume based data and minimum customer balances over a past period. Due to the variation in client working capital needs and transactions required by clients for particular markets it becomes difficult to provide a prescriptive quantitative set of requirements. However, supervisors should continue to review and standardise the bank methodologies with best practice during the monitoring period.

We do not believe that the question over methodologies should not influence the calibration of NSFR calculations, particularly as the concerns are already live in reporting for LCR. The requirements applied to the definition of Operational Deposits for LCR purposes (stripping out balances in excess of the operational relationship on a conservative basis) justify a substantially higher ASF. This would be consistent with the Sound Principles and the approach adopted for retail deposits for NSFR where the ASF factors are congruent with those specified for the LCR.

We ask the committee also takes into account that not giving appropriate recognition to the value of Operational Deposits would force banks to increase the amount of their wholesale funding with maturities greater than one year. This is another instance where banks will be faced with the choice of increasing their balance sheets or changing their business offerings and pricing to reflect the cost of not being able to use such deposits efficiently. Moreover it would increase the complexity of managing the Leverage Ratio. It is the BBA's opinion that an ASF at the 75% level, regardless of counterparty, would be consistent with the application of LCR criteria to define stable Operational Deposits under business-as-usual conditions.

## ASF factor for liabilities from non-bank financials

Whilst we acknowledge that a low ASF for short dated non-operational liabilities from financial institutions is broadly appropriate we consider that a 0% ASF across an entire portfolio of such liabilities covering all types of financial customers, including insurance companies, pension companies, client money, etc., is exceedingly conservative.

From a risk perspective, we believe that it is unreasonable to assume that such a portfolio provides no stable funding benefit over a one year horizon, especially outside of periods of liquidity stress. Diversification within such portfolios reduces the risk of 100% outflows and therefore a small amount of ASF is entirely appropriate.

From a wider economy perspective, we believe that a 0% ASF, combined with 100% LCR requirement, is likely to increase the risk in the wider system. These combined requirements will lead to financial institutions (including pension and insurance companies) having increasing difficulty in placing discretionary funds with low risk regulated counterparties. This is a trend which is already being observed within the market.

The combined requirements of the LCR and NSFR mean that accepting non-operational deposits from financial institutions will become wholly uneconomic for banks. On a marginal basis, banks will be required to place any funds raised from financial customers directly into central bank reserves. The 5% RSF attributable to other Level 1 HQLA means that even investment in government issued debt will not be a possible approach for banks.

As such, the BBA consider that a more moderate ASF for non-operational deposits from at least some subset of financial customers would be appropriate.

**RSF factor for Trade Finance Assets**

While we agree with the criteria for setting RSF for assets set out in paragraph 13, we are concerned that the wide scope of paragraph 32 (e) may have negative consequences for the supply of short-tenor on-balance sheet trade finance loans used to support international trade flows. Trade finance loans have three main characteristics which differentiate them from standard corporate loans; a short tenor, a self-liquidating nature, and a low risk of default:

Short tenor loans: trade finance related lending is typically short term with industry loan tenors between 30-190 days. By setting an RSF of 50% for these short term assets it would be assume that the loans display the same behavioural rollover assumptions as a maturing corporate loan with initial tenor above 1 year. Trade finance lending due to its nature would not typically have tenor over 12 months.

Self-liquidating: each loan is considered on a transaction by transaction basis meaning that there is no automatic rollover. Trade finance loans are typically linked to an underlying shipment or trade. Despite the client's credit standing, clients would need to submit documentary proof of the underlying trade/shipment or depending on the trade other transactional documents. A drawdown of funding cannot occur without these documents. As the loans are specific to a transaction, there is not client expectation of a rollover, unlike assets with a greater relationship driven requirement such unsecured working capital loans. These trade linked characteristics with no automatic rollover make it easier for banks to liquidate a trade finance loan, which is why the EU recognizes a 100% inflow for these loans in their calibration of LCR.

Low risk: trade finance lending is recognised as low risk with high recovery rates through possible sale of underlying goods with industry default rates and loss rates[1]. The credit risk profile of these loans is substantially better than other commercial loans offered on either unsecured basis or secured on illiquid fixed assets. In the same way that the standards differentiate between the funding requirements for lending to retail customers (RSF for mortgages versus other lending) it would be consistent with the NSFR standards for there to be some consideration of different stable funding requirements for non-retail loans.

[1] The International Chamber of Commerce (ICC) reviewed a data set of 8,133,031 transactions between 2008 and 2011 and found an average default rate on import loans of 0.016%, export loans (bank risk) of 0.029% and export loans (corporate risk) of 0.021%: International Chamber of Commerce; Global Risks Trade Finance Report 2013, Para 3.1, Figure 9.

Trade finance is primarily a low margin industry. There is a risk that setting disproportionately high stable funding requirements would negatively impact a bank's internal funds transfer pricing mechanisms in a way which would reduce the overall credit supply to the industry.

In considering an appropriate RSF for trade finance lending the potential impact on credit supply by adding an additional regulatory cost should also be taken into account. . Many regulators and central banks throughout the world have been careful in ensuring that regulations do not negatively constrain trade finance lending given its importance to economic growth in both developed and emerging markets. A regulatory requirement that builds a resilient banking sector should be pursued, but given the additional regulatory cost should not be set in a way that is overly conservative and cause a deadweight loss to the economy.

As the underlying trade transactions of trade loans are discrete, short term events, we believe that a 50% RSF is inappropriate and will increase the cost - and reduce the availability - of this vital source of finance for economic growth. The BBA support a 0%-10% RSF for any trade finance lending with residual maturity below 6 months a 15-25% RSF range for drawn trade finance transactions between 6-12 months in duration.

## RSF factors for equities

The proposed RSF for prime equities, those that are components of major indices, do not appropriately reflect their inherent liquidity value demonstrated by their resilient performance during the market dislocation and the transparency, structure and depth of the market. Equities are a highly liquid asset class and outperformed most HQLA level 2B assets and some 2A assets in the liquidity dislocation during the financial crisis. For this reason we recommend RSFs for prime equities to be set at 15%/20% (comparable to level 2a assets under the LCR). RSFs set at the proposed levels (50% - 85%) will lead to unintended negative impacts on market liquidity (due to wider spreads to offset higher holding costs) with real economy impacts (would impede firms from being able to hedge client risk, support new issuance and provide products). Regulators must differentiate between LCR haircuts, which are intended to address a 30 day period of high stress, and the NSFR which should address longer term structural liquidity mismatches and therefore alignment on the 50% haircut between the two ratios is inappropriate.

## RSF factor for physically traded commodities

We welcome the reduction in the RSF factor for physically traded commodities (other than gold) from 100% to 85%. However, we would suggest that one RSF factor for all physically traded commodities are over-simplistic as it does not take into account differing liquidity values for the underlying commodities. In particular, unallocated metal accounts, which are more akin to cash accounts, and warranted metals, have inherent liquidity value and deep markets. Therefore we would suggest that a lower RSF factor is more appropriate.

We would also highlight that holdings of stock are often part of other transactions (e.g. derivative forward sales and repurchase agreements). This type of trade is typically short-dated which is not reflected by a high RSF factor. A lower RSF factor, say of 50%, would be more appropriate, in line with the treatment of other short-dated non-HQLA assets.

Furthermore, we would argue that a RSF of 85% for gold does not appropriately reflect the liquidity characteristics of this asset class. It has been consistently demonstrated that gold is a highly liquid commodity class as reflected in bid/ask spreads and resiliency measures and is a run-to asset in periods of stress. We would advocate the re-classification of unencumbered gold within the 50% RSF bucket as set out in the December 2010 BCBS paper.

We hope these comments are useful and the BBA would be delighted to provide any future assistance we can.

Yours sincerely

Robert Driver
Policy Advisor
Prudential Capital & Risk
Tel: 020 7216 8813
Email: robert.driver@bba.org.uk