



**International
Banking Federation**

Pinners Hall
105-108 Old Broad Street
London EC2N 1EX

tel: + 44 (0)20 7216 8947

fax: + 44 (2)20 7216 8928

web: www.ibfed.org

Mr Stefan Ingves
Chairman
Basel Committee on Banking Supervision
Centralbahnplatz 2
CH-4002 Basel
Switzerland

Email: Stefan.ingves@bis.org

11 April 2014

Dear Mr Ingves,

Re: Comments on consultative document: “Basel III: The Net Stable Funding Ratio”

We appreciate the opportunity to review the consultative document, Basel III: The Net Stable Funding Ratio (NSFR), dated 12 January 2014. We welcome the clarification that the NSFR is not intended to be a one-year idiosyncratic stress test, but a structural liquidity ratio. This definition is appropriate in providing a sustainable business-as-usual approach to long-term funding to complement the Liquidity Coverage Ratio (LCR), which is based on an extremely severe short-term liquidity stress scenario.

We appreciate and support some of the Basel Committee’s recalibration of the NSFR, in recognition of significant potential unintended consequences that could arise. However, we question the reasoning behind some of the Available Stable Funding (ASF) and Required Stable Funding (RSF) factors for other products, and note that more quantitative impact analysis will be required before we can assess the appropriateness of the NSFR calibration. IBFed Members 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.

Such a quantitative impact analysis must also take into account the huge regulatory changes that have been and are being implemented in the financial sector, notably the Basel III related components for the banking industry, which will make the financial industry far more resilient to future shocks. Further, as a general matter, it is imperative that the ASF and RSF factors in the NSFR reflect a sustainable approach that is consistent with the role of the banking industry in providing market liquidity and maturity transformation to support the global economy.

Please find our comments on the consultative document below.

Key Messages

Definition of the NSFR as a non-risk based measure

While the NSFR is no longer described as an extended firm-specific crisis scenario, triggers are not provided to support the proposed ASF and RSF factors (e.g. credit rating downgrade). The ASF and RSF factors are not supported by risk-based analysis and are the same for any bank, irrespective of its financial strength, business model, risk profile and markets of operation. While this approach fulfills the Committee’s objective of simplicity we note that this approach will impact banks in an uneven way. Consequently, we believe that the ASF and RSF factors should not be calibrated too stringently

for any key banking products since it would otherwise force banks to make material changes to the transfer price for products to which extreme factors are applied without the benefit of a full understanding of the consequences in advance of the implementation. The QIS results over the next few years, together with projected changes in bank behaviours, will be a key resource for determining the appropriate calibration of the NSFR.

Additionally, the RSF matrix - and by extension the NSFR - relies heavily on LCR parameters. While we again recognise the simplicity of this approach, we believe that the use of LCR parameters 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-High-Quality Liquid Assets (non-HQLA) under the LCR, even though many of these should be assigned better structural liquidity values under a longer and non-stress scenario.

RSF Factors and Liquidation of Assets

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 Basel Committee's own January 2014 paper on *Guidance for Supervisors on Market-Based Indicators of Liquidity* where it is stated on page 1 that "*The liquidity value of an asset depends on the underlying stress scenario, the volume to be monetised and the timeframe considered*".
- 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 the normal course of business since they include:
 - (i) self-liquidating mechanisms that assure that both sides of the transactions would be taken off the balance sheet concurrently; and/or
 - (ii) exchange of initial/daily variation margins that mostly or fully neutralises the potential loss of liquidity value in the HQLAs. For example, total return swaps against equities and structured notes hedged in part or in full with securities.

This approach is particularly punitive for Level 2B and 3 assets. For example, senior tranches of various asset-backed securities, such as credit card receivables, auto loans, Federal Family Education Loan Program (FFELP) student loans and Commercial Mortgage-Backed Securities (CMBS) would be automatically assigned a punitive RSF factor of 85%, even if maturing within one year. While we are open to the methodology, we do believe that the RSF matrix needs for example to be revised to better accommodate high-quality ABS. The use of a maximum threshold (e.g. 25% or 50%) for all market liquid assets would also be a reasonable approach. Other liquid assets like major equities are also assigned RSF factors that are not consistent with the tenor of the metric and the level of stress.

Aligning HQLA definitions between the LCR and NSFR only has merit if it is recognised that from a risk-based perspective the universe of securities that can be liquidated over one-year time horizon in a non-stress environment is far greater than in a 30-day severe stress. We recommend that the haircuts should be lower to reflect this concept or to widen the definition of liquid assets for the NSFR to reflect market liquidity: a shorter than 1 year security should receive a 0% RSF factor; assigning a 5% RSF factor for all Level 1 government bonds until maturity is also inconsistent with the LCR and would be too high for shorter maturities.

Deposits from central banks with a residual maturity of less than 6 months should be treated in line with those funding from "sovereigns, public sector entities".

Finally, can the Basel Committee confirm its view on the treatment of gold (and other precious metals)? We believe that the treatment in NSFR 2014 should not lead to a worsening of treatment compared to the 2010 NSFR proposal unless there is a valid reason to do so.

Treatment of Operational Deposits and SME Deposits

While we welcome the incorporation, for the first time, of a stability factor for operational deposits (custody, clearing, cash management), we believe that the 50% ASF factor is too conservative for a structural measure of liquidity. This is especially true when one considers the requirements which govern the treatment of operational deposits, which have become progressively more stringent over time. This includes various qualification standards and the requirement to identify and exclude 'excess' deposits. As a result, the current definition of operational deposits produces a category of funding that is extremely stable, whether over a period of acute short-term stress or over a one year non-stress horizon. Therefore, we believe that operational deposits should be assigned an ASF factor of 75%. The IBFed supports ongoing work to simplify the definition of operational deposits based on easily available criteria.

Furthermore, the IBFed recommends that other deposits of non-financial customers could have a higher ASF factor since the NSFR is not based on a stress situation.

Inconsistency between ASF and RSF Factors

We believe that the net structural liquidity risk measured by NSFR for various combinations of products and counterparties described in three paragraphs (i.e. paragraphs 22(a-b), 29(c) and 32(e)) will be materially overstated. There is, for example, a material asymmetry between (1) the treatment of certain types of short-term secured funding (liability-ASF) and lending (asset-RSF) transactions for the same product, collateral and tenor, and (2) short-term secured lending transactions (asset-RSF) used to cover liquid asset short positions (liability-ASF), unless in both cases the asset is booked with a bank. A material NSFR gap also arises for assets maturing under 1 year that are booked with a non-bank financial institution (FI) or other key wholesale counterparty including a central bank or PSE in cases where there is no expectation of reputational risk related to the bank not rolling over loans/liquid assets as they mature (including central bank loans not qualifying as liquidity reserves). There should be no material differences in the NSFR risk profile of these combinations of transactions across products, securities, and client types. We believe that the resulting NSFR gap should be zero or very small, and not 50%.

We provide the following examples to illustrate our point:

- **Matched book secured funding transaction:** There is material asymmetry between the treatment of certain types of short-term secured funding (liability) and lending (asset) transactions even for the same product, security, and tenor. For example, if a bank does an overnight short-term repo and an overnight reverse repo underpinned by Level 1 HQLA with two different clients, irrespective of the counterparty with which the bank books the repo, paragraph 22(a-b) applies (0% ASF). If the offset trade is booked with a bank, paragraph 29(c) applies (0% RSF), leading to a neutral (and reasonable) NSFR position between the two trades. However, if the counterparty on the reverse repo is not a bank, paragraph 32(e) applies (50% RSF), leading to a NSFR gap of 50% for the notional amount of the transaction when it is a short-term matched book transaction of the highest quality.
- **Short position:** Short liquid asset positions will be treated as per paragraph 22(b). If the short position is covered with a bank counterparty, paragraph 29(c) applies, leading to a neutral NSFR position. However, if the reverse repo is done with any other counterparty, the same issue as above arises. Shorting HQLAs to manage interest rate risk in fixed income portfolios should not be discouraged by the BCBS. This would otherwise lead to increased usage of derivatives to hedge market risk and reduced market liquidity in bond markets.

- **Short term investments of capital or long term debt proceeds and surplus core deposits:** If a bank's treasury department chooses to invest surplus cash in a short-term reverse-repo transaction collateralised by Level 1 assets with a non-bank counterparty, we believe that an RSF factor of 50% will apply, but a 0% RSF factor applies to an uncollateralised loan to a bank. This rule would eradicate half of the ASF factor of 100% associated with long-term debt or capital funding. Given that the bank's unsecured and secured risk appetite for other banks is limited, unless the rule is changed, banks will be provided with an incentive to buy short-term HQLAs instead of doing reverse repos of HQLAs, when we believe the BCBS should be indifferent between either choice from a liquidity management perspective.
- **Liquid assets maturing under 1 year:** Where short-term transactions are booked with or issued by counterparties like non-bank financial institutions, central banks (other than reserves) and Public Service Enterprises (PSEs) for which there is no reputational risk not to renew these assets as they mature, an RSF factor of 50% per paragraph 32(e) is not appropriate. The short-term money markets for non-banks and certain central bank programs (e.g. the Federal Reserve Board (FRB) Reverse Repo facility) will be materially affected if term funding has to be raised against these assets. Consistent with the changes recommended below to paragraph 29(c) and the original 2010 NSFR proposal, a 0% RSF factor should apply to any money market assets or securities maturing within one year, and to any loans (assets) to central banks maturing under 1 year unless encumbered.

We reiterate that future QISs should be used to quantify the potential impact of this proposal on various subsets of secured funding and lending transactions underpinned by liquid assets.

For balance, we also provide one example where the outcome of the new NSFR rules would in our opinion overstate a bank's liquidity:

- **Long-term repo and short-term reverse repo:** Where a term repo (e.g. against government bonds) with a maturity greater than 1 year is conducted with one client and a short-term reverse repo with a maturity under 6 months is conducted with another client, the ASF factor per paragraph 18(c) would be 100% while the RSF factor would either be 0% for a bank counterparty per paragraph 29(c) or 50% for other counterparties per paragraph 32(e). This would leave the bank with an NSFR surplus when we believe the NSFR should be neutral. The need to rollover the reverse repo to cover the short position that would otherwise arise is not captured in paragraph 28 because the focus is on the cash not securities leg of these transactions (unlike in the LCR).

Treatment of Derivatives

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 welcome that BCBS is considering changes for dealing with derivatives and other assets/liabilities as the current suggested NSFR treatment of derivatives is not appropriate. The vast majority of centrally cleared and OTC derivatives are margined on a daily basis. This collateral significantly enhances the liquidity value of the transactions and, from a funding perspective, helps to keep the positions fully self-funded. In view of this prudent risk management of derivatives and impending regulations with respect to collateral management the IBFed recommends the following treatment with respect to variation margin:

- *Step 1: calculate the net derivatives payables and net derivatives receivables in accordance with ISDA agreements (or similar) where possible.*

- *Step 2:*
 - *2a: calculate the net residual derivative payables amount by deducting the fair value of any variation margin posted from the payables amount calculated in step 1.*
 - *2b: calculate the net residual receivables amount by deducting the fair value of the rehypothecable variation margin received from receivables amount calculated in step 1.*
- *Step 3: The amounts calculated in step 2a shall be subtracted from the amount calculated in step 2b:*
 - *For residual net derivative payables, a 100% ASF factor should apply.*
 - *For residual net derivative receivables, a 100% RSF factor should apply.*

Initial Margin on the other hand, should be recognised symmetrically (e.g. equal ASF/RSF assumptions), depending on the maturity of the transactions they relate to:

- *0% RSF/ASF for transactions with a maturity below 6 months.*
 - *50% RSF/ASF for transactions with a maturity between 6 to 12 months.*
 - *100% RSF/ASF for transactions with residual maturity beyond 12 months.*
 - *if the received initial margin is not re-hypothecable, ASF is set to 0%.*
- *collateral that is in excess of contractual agreements should receive a 0% RSF/ASF.*

ASF/RSF factors that associate with monetary measures of central banks should be realigned

The NSFR should not differentiate incentives for private banks to cooperate with specific central bank monetary measures to control the money supply. For some central banks, it may constrain their flexibility to apply specific measures. To be specific, when central banks try to absorb money using repos (i.e. reverse-repos with central banks as counterparties from private banks' perspectives), an RSF factor of 50% is considered to be applied according to the consultative document. Such treatment may lower the incentive for private banks, relatively speaking, to cooperate. Thus, the RSF factor should be 0%.

Also, by paragraph 22(a), an ASF factor of 0% would apply for funding from central banks with a residual maturity of less than 6 months. This may be a treatment that results out of a concern that private banks may use the money provided by central banks through financing operations using repos to finance long-dated assets. But there would not be any problem when banks use the fund to finance short-dated assets. To avoid penalising funding from central banks through monetary operations using repos, the ASF factor should be in line with that of most of the short-dated assets, which is 50%.

In addition, although the NSFR and LCR are based on different risk horizons, it is neither rational nor consistent that secured funding from central banks is assumed to be rolled over in the LCR, but not at all in the NSFR.

Trade Finance and Factoring

The IBFed recommends excluding 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 financial institutions, in order to avoid detrimental adaptations of activity.

The IBFed supports a 0% factor for the RSF factor under paragraph 32(e) for trade-finance loans of less than six months' tenor. This would appropriately reflect the short term, low risk, self-liquidating nature of these products and their importance to the real economy. Additionally, we suggest defining a commensurately low RSF factor for off-balance sheet trade-finance exposures rather than leaving this to national discretion, as is currently suggested under Table 3. This would better ensure a level playing field in the regulation of financial products that support global trade in goods and services.

Clarification of underlying assumptions and objectives

Further clarity would be desirable on the assumption of bank behaviour that “*banks may seek to roll over a significant proportion of maturing loans to preserve customer relationships*” (paragraph 13(b)). It could be presumed from this assumption that no idiosyncratic stress scenario is intended but a non-stress / normal condition should be considered. However, without an explicit statement to this effect, there is difficulty in judging whether each factor is at its proper level, or more calibration is actually needed. It would be closer to the actual measurement of risk, and more efficient for those banks that adopt the Internal Ratings-Based Approach, to use the same approach to judge criteria shown in paragraph 33.

Furthermore, changes had been made to reduce cliff effects around the boundary line of one year. Together with the revisions of factors below and above the line, a period of less than one year has been divided into two buckets in some categories. Also, different factors are now applied for these buckets. This may be derived from the premise that “*longer-term liabilities are assumed to be more stable than short-term liabilities* (paragraph 12(a)).” But it is not clear what the aim is by dividing the residual maturity period (i.e. period of inability to sell, or transaction period) of less than one year, and applying different ASF/RSF factors. Also, if the RSF factor represents the “proportion of roll-over,” the residual maturity does not have much meaning, and the same RSF factor should apply to those assets under the same category with residual maturity of less than one year.

Overall, we believe that without a specific aim or rationale, the ratio would have very little practical application for liquidity risk management in a bank, especially since it does not appear that it can be used effectively for internal control. The IBFed urges the Committee to further engage in an open dialogue with the industry on the assumptions and aims of the NSFR.

We thank you for taking our comments into consideration and look forward to future discussions on these issues.

Yours sincerely,



Mrs Sally Scutt
Managing Director
IBFed



Debbie Crossman
Acting Chair
IBFed Prudential Supervision Group