

Société Générale's response to the Basel Consultative Document Basel III: The Net Stable Funding Ratio (BCBS CD271)

Société Générale appreciates the opportunity to comment on the BCBS proposal on the consultative NSFR framework.

We support the Committee's objective to maintain a stable funding profile in relation to the composition of the banking sector's assets and off-balance sheet activities.

We also welcome the changes that have been made into the present proposal that defines the NSFR as a long term structural liquidity risk metric which complements the short term liquidity ratio based on an extremely severe liquidity stress scenario.

The Committee made some important changes into the framework in order to recognize maturity transformation on retail and corporate banking activities:

- Increased stability of retail and operational deposits
- Partial roll of wholesale funding with residual maturity between 6 and 12 months
- Required stable funding of short term loans cannot exceed 50%
- Required stable funding of long term loans to non financial customers is limited to 85% instead of 100%

Despite these positive changes we remain concerned by the level of stable funding required for short term investment banking activities. We see the current NSFR for these activities as the extension of the LCR during 6months.

While we fully support IIF, EBF and FBF responses, we would like to illustrate our main concerns on the proposed framework which are listed below:

1. RSF of equities
2. RSF on short term reverse repo with non bank financials
3. Netting of derivatives
4. Treatment of trade finance
5. Accruals

1/ RSF of equities

We recognize that the RSF factor has been lowered for financial equities. However, a RSF of 85% implies that 100% of the equity portfolio held in trading books should be at any time refinanced over 6 months which means **a funding structure with a maturity of 5 years** (cf annexure).

The NSFR assumes that the equity portfolio is supposed to be held perpetually in the balance sheet. This requirement does not recognize the intrinsic liquidity of equities listed in major indexes nor that **equity portfolios are held in trading books in order to hedge derivative portfolios¹** in order to be

¹ See Basel III definition of capital - Frequently asked questions December 2011 (update of FAQs published in October 2011) , FAQ 17 to Paragraphs 78–89 (Investments in own shares, investments in the capital of banking financial and insurance entities and threshold deductions) available at <http://www.bis.org/publ/bcbs211.pdf>.

compliant with market risk exposure limits (these requirements lead to an insignificant exposure in line with a delta neutral position).

Banks commonly act as market intermediaries to facilitate client trading strategies. There are derivatives linked strategies where banks carry cash equity inventory to facilitate these strategies. However the bank does not face any material market or funding risk, because symmetrical unwind of the derivatives and its hedge (equity) is assured through credit, liquidity, and market risk safeguards.

There is a lack of consideration in the LCR and NSFR for these linked transactions where both the asset and the liability are part of a single structure:

- Equities are hedging equity linked swaps, total return swaps, futures, forwards...

The linkage between equities and their hedge ensures simultaneous unwind/exit at maturity of the derivative. Market 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.

Futures market is a good illustration of linked transactions. 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. 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.

We understand that the RSF factor aims also to capture the franchise risk related to the bank's businesses.

The franchise risk on equities shall be seen as the franchise risk related to the derivative portfolio. In case of a market stress on short term funding, a derivative portfolio can be hedged by another derivative transaction instead of a cash-equity hedge.

Finally, we would like to highlight that LCR already requires to fund cash-equity positions beyond the maturity of the derivative portfolio due to the haircuts applicable to equities (50% resp 100% for non financial and financial equities). The liquidity gap is therefore already positive under stressed conditions. A business as usual scenario should avoid creating overly cautious positive gap which could create unintended consequences in a situation where the assets are not rolled over as supposed by the NSFR.

As a result, our recommendation would be :

1. Major market, main index equities should receive an RSF factor of 15%; All other major market equities traded on an exchange, but not included in the main index, should receive an RSF factor of 50%. All other equity should receive an RSF factor of 85%.

These RSF factors should be weighted for equities held to hedge market risk exposure of derivatives transactions according to the maturities of the derivatives:

- An asset that is held to hedge a derivative with less than 6 month maturity should be weighted with 0% factor. 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.
 - This recommendation is limited to equities:
 - traded on major markets, listed on major indexes
 - Held in trading book
 - Having deep repo market
 - Hedges derivative transactions.

The following table sums up RSF factors proposal by type of securities and maturities

	In a linked structure (Hedging market risk exposure)			Not linked
	< 6 months	Between 6 months and 1 Year	More than 1 year	
main index equities	0%	7.5%	15%	15%
Other market equities traded on an exchange	0%	25%	50%	50%
Other equities	0%	42.5%	85%	85%

2/ RSF short term reverse repo with non bank financial

Through their market making activities, banks ensure the liquidity of sovereign debt on the primary and the secondary market. At any time banks are buying and selling sovereign debt to satisfy investors demand. In order to offer low bid-offer spread, banks do not hold large inventories: long positions are refinanced through repo and short positions are covered through reverse repos.

A short sales covered by reverse repo is liquidity neutral. **We therefore recommend that these positions should be netted out on an ISIN/CUSIP basis (the same calculation is already performed for the liquidity buffer).**

Moreover, **we recommend that :**

- Reverse repo with residual maturity less than 6 months performed with QCCP and other regulated counterparties as insurance companies shall receive a RSF 0%.
- RSF of 50% shall be lowered for reverse repo with residual maturity less than 6 months by taking into account the liquidity value of the collateral received.

3/ Netting of derivatives

The Mark-to-market of derivative operations represents the present value of the future cash flows, consequently derivative payables and receivables have similar characteristics in terms of funding. We would like the Basel Committee to acknowledge the economical symmetry when considering ASF and RSF factors but we understand that the 100% ASF factor might be difficult to revisit; as a result minimum netting should be allowed.

For derivatives that are not under margining set, we appreciate that net receivables and payables are netted out on a global basis. We recommend maintaining this treatment.

Derivatives that are under margin requirement are self-funded. The collateral that is posted represents the value of the MtM. This means that the MtM does not need additional funding requirement. The collateral received / posted should be netted from the MtM to the extent that the collateral received has a rehypothecation right.

We recommend that the collateral both received and posted should be netted from derivative receivables and derivatives payables by valid master agreement.

The residual MtM receivable should be netted out from the residual MtM payables together with derivatives without margining set.

Specific treatment Initial Margin

Initial margin protects counterparties against market volatility in the event of a default. Initial margin related to the bank's own derivative portfolio is posted to CCP, could require stable funding but should receive a consistent treatment between CCP and brokers.

For example, when a bank sells a future, IM is posted to a prime broker which posts the IM to a CCP. If the IM posted to the CCP requires a stable funding, i.e. RSF 100%, then the IM received by the CCP and the prime broker should receive the same treatment, i.e. ASF 100%. There is no reason to suppose that the IM requires a stable funding for the bank, but does not provide stable funding to the prime broker or to the CCP.

We recommend that IM receive symmetrical treatment across market players (banks, brokers, CCP). The RSF/ASF weighting might be different depending on the tenor the operation. For sake of simplicity an equivalent 50% might be given.

This issue is even more important for prime brokers. Prime brokers' core business consists in offering execution and clearing services on Exchange traded derivatives markets. In this context and in accordance with local regulation, customer funds received by a broker may be subject to segregation requirements. Segregation consists mainly in the separation of customers assets from the broker's own funds (ring-fencing). It notably involves that customers funds deposited to purchase, margin, guarantee or secure futures and options transactions be accounted for separately and be held for the benefit of customers and deposited under an account name that clearly identifies them as such.

Segregation regimes differ from one jurisdiction to another.

- USA is subject to the Commodity Exchange Act and to CFTC and SEC rules ;
- a. UK is subject to the FSA's Client Assets protection rules (CASS) ;
- b. Canada (NECA) is subject to the Investment Industry Regulatory Organization of Canada (IIROC Rule 17.3) and to the Canadian Investor Protection Fund ;

- c. Australia (NEAU) is subject to the Australian Securities and Investments Commission rules (ASIC Market Integrity Rules) notably with regards to the treatment of client monies;
- d. Singapore (NESG) is supervised by the Monetary Authority of Singapore with the exchange rules as supplement. Those rules include the treatment of the client monies.

In the European Union the application of the EMIR regulation is expected to extend segregation requirements for direct market participants. In the US, the LSOC (Legal Segregation with Operations Commingling) rule will extend the application of segregation requirements to cleared swaps. Uncleared derivatives are also likely to be subject to similar requirements.

According to local Regulations applicable to segregated funds, prime brokers are required to separate their own funds from customers' funds (ring fencing principle) and to hold them in specifically designated accounts.

Segregated balances are therefore inherently linked to client deposits: reduction in **clients' deposits will lead immediately to release of funds from segregated accounts to finance the repayment**. In case of clients' deposits run-offs, segregated assets act as natural and steady offset to clients' deposits run-offs (outflows).

Customers' deposits are placed in individual or aggregated segregated accounts and invested in short-term deposits and loans or highly liquid assets (HQLA). Segregation regimes define authorized investments in most jurisdictions. These HQLA assets have an intrinsic liquidity and are directly available in the event of a severe liquidity stress.

As a result, we recommend that activities performed under segregation regime be neutral for the purpose of the NSFR.

4/ RSF of Trade Finance operations

The proposed framework requires 50% stable funding outstanding at all times for short-term financing provided to non-financial customers. Thus, additional funding resources are needed with a maturity at origin of at least 1 year.

On the other hand, trade-finance transactions usually last about one month and the operations have a "self-liquidating" structure.

This gap would significantly raise the cost of financing this activity and create ALM risk as outstanding amounts can vary quite quickly.

Trade-finance transactions are not general-corporate funding provided to clients, which could be expected to be more or less permanently needed. They are tied to specific trade-transactions (a cargo of oil going from one port to another), usually backed by security over the shipment, **and self liquidating with the proceeds of the delivery of the goods**.

While we understand that the NSFR could also serve macro-economic stability purposes, we would like to point out that mobilizing more expensive funding resources would ultimately increase costs for the whole economy. It might also push some of this funding outside the banking sector, for example increasing demand for trade credit on suppliers and clients balance-sheets. This issue is not limited to trade finance and also concerns more generally the financing of trade receivables.

We would recommend reducing the RSF of self-liquidating short-term trade finance transactions to 0%.

5/ Treatment of accruals

We would like the BCBC to confirm that netting of accruals is still allowed under this new NSFR version. As stated in response to FAQ on May 18, 2010², accruals were reported net in previous quantitative impact study.

Accruals do not represent any funding risk and are quite stable from one closing period to another, since accruals come from :

- Difference between trading and settlement date (securities purchased with settlement to be executed); and
- Differences between the cashflows and their accounting recognition (fees received upfront that are taken accrued in the P&L),

The IFRS accounting standards enable to identify the same type accruals in the asset and liability side.

We recommend to net accruals between assets and liabilities that have the same nature. A net asset would receive a 100% RSF, a net liability would receive a 0% ASF.

ASSETS	LIABILITIES
CURRENT TAX ASSETS	CURRENT TAX LIABILITIES
PREPAID EXPENSES - EMPLOYEE BENEFITS	DEFERRED INCOME - EMPLOYEE BENEFITS
INCOME RECEIVABLE - EMPLOYEE BENEFITS	ACCRUED EXPENSES - EMPLOYEE BENEFITS
PREPAID COMMISSIONS - FINANCIAL GUARANTEE RECEIVED - CUSTOMERS	DEFERRED FEES ON FINANCIAL GUARANTEE GRANTED - CUSTOMERS
PREPAID COMMISSIONS - FINANCIAL GUARANTEE RECEIVED - BANKS	DEFERRED FEES ON FINANCIAL GUARANTEE GRANTED - BANKS
FEES RECEIVABLE ON FINANCIAL GUARANTEE GRANTED - CUSTOMERS	ACCRUED FEES ON FINANCIAL GUARANTEE RECEIVED - CUSTOMERS
FEES RECEIVABLE ON FINANCIAL GUARANTEE GRANTED - BANKS	ACCRUED FEES ON FINANCIAL GUARANTEE RECEIVED - BANKS
OTHER INCOME RECEIVABLE	OTHER ACCRUED EXPENSES
OTHER DEBIT ADJUSTMENT ACCOUNTS	OTHER CREDIT ADJUSTMENT ACCOUNT
SETTLEMENT ACCOUNT ON SECURITIES TRANSACTIONS (ASSETS)	SETTLEMENT ACCOUNTS ON SECURITIES TRANSACTIONS (LIABILITIES)
OTHER SECURITIES TRANSACTIONS (ASSETS)	OTHER SECURITIES TRANSACTIONS
RECEIVABLES/CLEARING HOUSES	AMOUNT OWED TO CLEARING HOUSE
GUARANTEE DEPOSITS PAID - SECURITIES TRANSACTIONS (ACCRUED OPERATIONS) AND OTHER DEPOSITS PAID TO GUARANTEE LIABILITIES	GUARANTEE DEPOSITS RECEIVED - SECURITIES TRANSACTIONS (ACCRUED OPERATIONS)
GUARANTEE DEPOSITS PAID - OTHERS	GUARANTEE DEPOSITS RECEIVED - OTHERS
SUNDRY DEBTORS	SUNDRY CREDITORS

² See BcBS - **Frequently asked questions on the comprehensive quantitative impact study** - 18 May 2010

How should accruals be treated in the NSFR? In the current text, it looks like accruals to receive and to pay cannot be netted and accruals to be received should be funded for the entire amount by LT funding.

Please report accruals on a net basis with net accruals to be received on line 249 "other income generating assets (eg minority interests)". Net accruals to pay can be reported on line 188 "all other liabilities and equity not reported above"

In conclusion, we would like to reiterate that this comments are not meant to be exhaustive. Our intent was to stressed concerns of particular importance for our bank such as equities market, derivatives and trade finance. However we share concerns and support recommendations raised in IIF, EBF and FBF letters. We appreciate your consideration of these comments. If you have any questions or comments on these observations, please contact dorothee.bucquet@socgen.com.

Very truly yours,

Dorothee Bucquet

Head of prudential regulation on liquidity

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Annexure : smoothed amortization structure

We are aiming to illustrate what type of funding structure is required to fund an asset that has a RSF of 85%.

The funding structure will be based on the assumption that each month an equal tranche is renewed on an equivalent maturity.

Example:

For a 2 years maturity smoothed funding structure, each month 1/24th of the funding matures and rolls on a 2 years maturity.

With such a funding structure:

- 50% of the funding is over 1 year
- 25% between 6 months and 1 year and
- 25% less than 6 months.

=>The corresponding ASF is 62,5%.

Conclusion:

A funding structure that has an ASF of 85% at any time will require to extend the maturity of each tranches to 5 years.

An ASF of 50% will correspond to a 1,5 years maturity.