

11/04/2014

Basel Committee  
on Banking Supervision

## **Consultative Document**

### **Basel III: The Net Stable Funding Ratio**

#### **Key suggestions to the current NSFR proposal**

- We suggest lowering the RSF-factor on encumbered mortgage loans from 100% to 85%. We also suggest setting the ASF-factor to 50% (from 0%) for covered bonds with remaining maturities shorter than six months.
- We propose an ASF-factor of 75% (from 50%) for corporate deposits.
- We suggest that total return swaps that have stable funding are assigned an RSF-factor of 0% (from 50%).
- We suggest that all loans which are fully secured with HQLA assets and have a maturity below six months are assigned an RSF-factor of 0% (from 50%).

#### **Introductory remarks**

The Swedish Bankers' Association welcomes the opportunity to give feedback on the new proposal for NSFR. We appreciate that the BCBS has changed some important parts of the measure, especially the introduction of a new maturity bucket (6m-1y) that will lead to smaller cliff effects and will acknowledge the value of a wider variety of funding sources. The overall changes will mitigate some of the severe effects that many of the critics pointed to in the original proposal (2010). However, the revised proposal will, in our view, still lead to problems for the real economy, without necessarily strengthening financial stability.

In the forthcoming text we focus on a number of issues which in our view are the most important to be dealt with further in the process of finalizing the NSFR requirement. Our suggested changes to the NSFR proposal aim to be beneficial, or at least neutral, from a financial stability perspective. The issues we focus on are:

- 1) the treatment of covered bonds,
- 2) the treatment of corporate deposits, and
- 3) the treatment of certain types of securities trading activities.

## **Treatment of covered bonds**

### **Problem**

Covered bonds with the highest ratings (Swedish covered bonds are rated Triple-A) combined with covered bonds legislation in place, constitute a stable funding source for banks. The proposed NSFR is constructed in a way that provides incentives for banks to abandon this stable funding source for more unstable funding sources, such as senior unsecured bonds.

With almost 3 trillion EUR outstanding at the end of 2012 covered bonds are playing an important role in the European capital markets. Covered bonds are primarily used as a stable funding source for retail mortgage loans in markets where retail deposits are a scarce resource, as a direct result of the structure of the local pension systems and savings patterns in the society.

The proposed NSFR penalizes funding mortgage loans with covered bonds compared to unsecured funding. Described simply, unencumbered mortgage loans will have an RSF of 65% (irrespective of the remaining duration of the mortgage loan) and the bonds used for funding will have an ASF of 100% for the part that has a remaining duration of >1Y. Hence, a bank that only provides mortgage loans funded by senior unsecured debt (which is usually relatively less stable as a funding source compared to covered bond funding, reflected both in pricing and in rating) will have an NSFR >100%. The exact NSFR ratio will vary at each point in time with the remaining duration of the senior unsecured debt as parts of the funding will fall into the 50% ASF time bucket (>6M<12M) and parts into the 0% ASF time bucket (<6M).

However, if the mortgage loans are funded by covered bonds, the NSFR fully reflects the encumbrance of these loans, and the RSF-factor increases to 100%, whereas the covered bonds have the same ASF-factors as senior unsecured debt as described above. This will effectively eliminate the possibility to fully match the asset with the liability as it would result in an NSFR of <100%, which is also lower compared to the example above.

In our view, the difference in treatment between funding from senior unsecured debt and covered bonds does not reflect the difference in liquidity risk in a correct way.

Furthermore, a more detailed assessment between the two examples above (see Appendix 1) shows that a bank using senior unsecured funding with a shorter initial average funding duration (4.4yrs) will achieve a higher NSFR (135%) compared to a bank using covered bonds with a longer initial average duration (7.2yrs) that will achieve an NSFR of 110%. It is unfortunate if longer duration – which indicates a more stable funding situation and a lower degree of liquidity funding risk – would have a lower NSFR keeping other parameters equal (in the example in Appendix 1,

both banks are able to achieve the desired funding mixes at the same funding cost as a spread over STIBOR).

The NSFR also treats funding through deposits more favourably than funding through covered bonds. A bank can use a portfolio of mixed depositors (including deposits that are not covered by a DGS) as a funding source and get a better NSFR than if it uses covered bonds. Even if the maturities of the deposits are O/N, they still obtain a more beneficial NSFR treatment as a funding source for mortgages than long-term covered bonds.

In summary, our view is that the NSFR proposal provides incentives for banks, which currently fund retail mortgage loans with Triple-A funding instruments – with well-documented and proven availability and stability even under stressed conditions – to change the funding mix towards more unstable funding sources.

### **Proposal**

A less discriminatory treatment of funding by covered bonds could be achieved in two ways;

Firstly, we suggest lowering the RSF-factor on encumbered mortgage loans from 100% to 85%. The BCBS has chosen to let unencumbered mortgage loans have a lower RSF-factor (typically 65%) compared to other unencumbered loans (85%). Given this favourable treatment of mortgage loans, our view is that also encumbered mortgage loans should have a lower RSF-factor compared to other encumbered loans, e.g. 85% instead of proposed 100%.

Secondly, we suggest that the ASF-factor on maturities shorter than six months should amount to 50% for covered bonds. The rationale is the empirical proven stability that covered bonds have as a funding source. This applies to covered bonds with the highest rating (AAA/Aaa), issued under an existing legislation, where the probability that refinancing would become difficult is very low. Also, a higher ASF-factor for short maturity covered bonds is logical, since it maintain some symmetry between assets and liabilities.

It would be unfortunate if covered bond funding, which has proven to constitute a very stable funding source for banks, would be treated unfairly from an NSFR perspective due to the inclusion of encumbrance in the metric. If banks change their funding mix, i.e. use less covered bonds, this will lead to a more unstable financial sector because the alternative wholesale funding sources are not as stable and reliable as funding through covered bonds.

## Treatment of corporate deposits

### Problem

Corporate deposits from non-SMEs have an ASF-factor of 50%, which is lower compared to retail deposits (having an ASF-factor of 90 or 95%). In our view this does not reflect the stability of corporate deposits compared to retail deposits.

The cliff effect from different types of deposits depending on the size of the company is substantial and may have unintended consequences on banks' abilities to price and attract stable sources of funding. SMEs are treated as retail deposits with a higher (90%) ASF-factor compared to 50% for "large" non-financial companies. The difficult, and sometimes arbitrary, classification of what constitutes an SME will mean that some depositors will be treated (e.g. priced) as retail and others, only slightly larger companies, will be treated (priced) as large companies. A consequence will be that customers move between categories over time as the deposit changes in size (which is common especially for mid-sized companies) – something that will drive NSFR volatility for many banks.

In addition to this, historical data shows that corporate deposits in large Swedish banks are stable over time. Even though the NSFR is not intended to reflect a stressed situation, we can see that outflows even during severe stressed conditions are fairly small. Also, under the LCR, the stability of (non-financial) corporate deposits amounts to 60% under stress following the 40% outflow assumption, whereas the stability-weighting of the same type of deposits is lower under the NSFR through the 50% ASF-factor. This, in our view is an inconsistency which is difficult to understand.

The table below shows the shares of quarters, in which the larger Swedish banks have outflows from their corporate and retail deposits exceeding certain levels.

*Table 1: Share of quarters with different outflows from deposits in four banks in Sweden*

#### Corporate deposits

Bank	Share of quarters with outflows large than			No. of quarters
	5%	10%	15%	
A	21%	4%	0%	24
B	26%	9%	0%	23
C	17%	4%	0%	23
D	17%	0%	0%	24

#### Retail deposits

Bank	Share of quarters with outflows large than			No. of quarters
	5%	10%	15%	
A	4%	4%	4%	24
B	0%	0%	0%	23
C	0%	0%	0%	23
D	0%	0%	0%	24

The table shows that corporate deposits have a higher volatility when it comes to smaller outflows (i.e. outflows of less than 15%). On the other hand, this volatility difference between corporate and retail is not observed for larger outflows. Actually, the one (1) instance of the combined 94 quarters where an outflow larger than 15% is recorded is linked to retail deposits and not corporate.

As the data goes back to January 2008, the results include and spans across the financial crisis. The data illustrates that quarterly outflows of more than 10% are very rare, even under the stressed conditions of the financial crisis.

The conclusion is that corporate deposits seem to be treated unfairly harsh from an NSFR perspective if the ASF-factor is capped at 50%. A possible consequence is that there will be incentives among banks to decline corporate deposits, which up until now have been considered and used as a stable funding source. Banks will also be forced to increase their market wholesale funding as a direct result of the treatment of corporate deposits under the NSFR which could increase banks' wholesale funding dependence and expose banks to more market-driven volatility, which in itself may threaten financial stability on an aggregated level.

Corporate deposits are furthermore an important service for the corporate sector and the real economy. If banks impair their service to corporate customers it will have a negative effect on the liquidity in the real economy.

### **Proposal**

We suggest a closer gap between the ASF-factors on retail and corporate deposits based on *i)* it reduces cliff effects between SMEs and "large" corporate where definition is difficult and also sometimes arbitrary, and *ii)* corporate deposits are more stable than current NSFR proposal acknowledges, as data also shows.

Based on these arguments, we propose an ASF-factor of 75% for corporate deposits. A factor of 75% is still more conservative than any of the actual outflows that banks in Sweden have experienced, including the time period during and following the crisis in 2008.

## **Treatment of certain types of securities trading activities**

### ***Example 1: Total return swaps***

#### **Problem**

Total return swaps are derivatives that will deliver a return linked to an asset or an index. These structures can be self-funded and hence liquidity neutral. An example would be a fund, or any other non-bank, that wishes to outsource part of its exposure to certain assets. By entering into a total return swap with a bank the fund can obtain this exposure without using its own balance sheet. The exposure is on the banks balance sheet, as a hedge for the outflow according to the total return swap, but totally funded by the client. In spite of the fact that this structure has no liquidity risk for the bank – being entirely financed by the client – the banks' exposure is assigned an RSF of 50-100% in NSFR.

Because of the longer funding that is needed, according to the proposed NSFR, the costs of offering total return swaps will be much higher than today. Due to this increase in costs, the bank may choose to enter the transaction and lose money, or not to offer the service. The customer would then turn to another vendor outside the regulated banking sector with no legal requirements to comply with the NSFR.

#### **Proposal**

We suggest that these types of exposures (as described above), that have stable funding, should not be assigned any RSF requirement at all. The construction of total return swaps is liquidity neutral for the bank if they are handled this way. The requirements to be fulfilled should be that the counterparty has certain levels of credit worthiness, or that the contract can be broken by the bank.

### ***Example 2: Repos***

#### **Problem**

The proposed NSFR regulation treats repo transactions with non-bank counterparties as cash-collateralised loans. This means that short term repos with corporate counterparties will require 50% stable funding. Having a 50% RSF-factor for a short term loan where the bank has a Triple-A collateral is unnecessary high and would have a negative impact on repos, which could force banks to increase pricing for this product (especially in combination with other regulations such as MiFID). Repos are important for the general liquidity in the market.

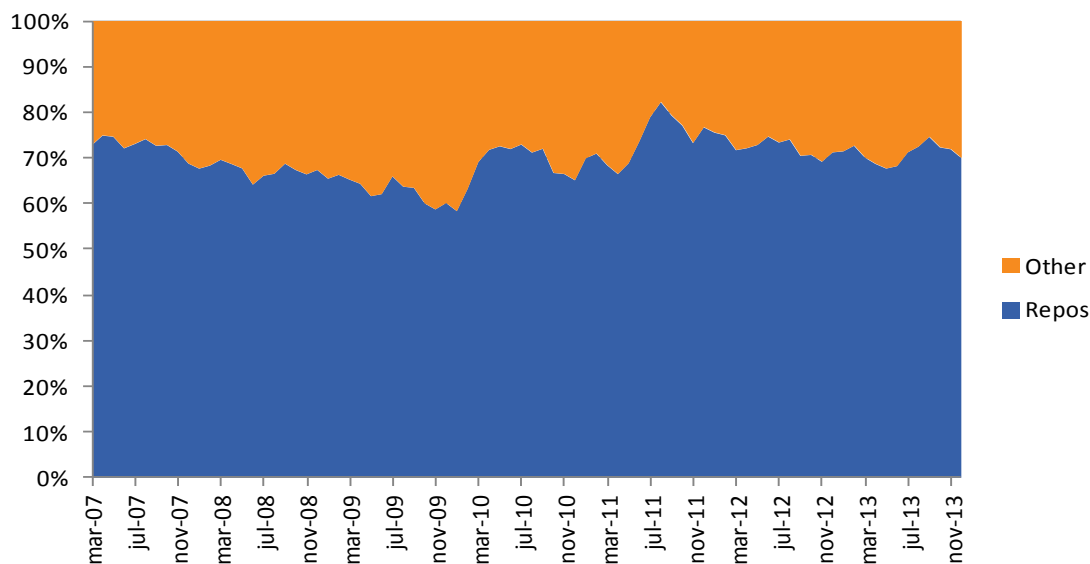
E.g. an insurance company could repo an AAA covered bond with bank A for 30 days. Bank A could then mirror this repo transaction with bank B. That means that Bank A has match-funded the transaction and all the transactions are fully covered by AAA assets. But bank A will get an RSF-factor of 50% because of the money

transaction with the insurance company. No ASF will come from any of the other transactions. Funding for the original (reverse) repo transaction that will be NSFR neutral has to be over one year long. With a normal yield curve this will have a negative impact on the cost for this transaction. For weak banks the impact will be more severe. In the Swedish market we would expect that the costs for a two day repo could increase from 2-4 bps to potentially 40 bps. If a bank has a low NSFR it will be forced to decide if repo operations should be a service that the bank offers.

Market makers will need to increase margins to be able to handle the requirements that come with the proposed NSFR. Higher transaction costs will lead to lower liquidity in the markets for the assets. Weak banks, with high funding costs and a low NSFR, will not be able to be part of the repo-market.

As an example of how important the repo market is for a liquid secondary market the figure below shows the Swedish covered bond markets divided into repo transactions and other transactions (client transactions, market maker transactions, etc).

*Figure 1: Monthly turnover of covered bonds*



Source: The Riksbank

## Proposal

There is a need for repo transactions in capital markets in order to keep markets liquid. Therefore, it is important that repos receive an appropriate treatment in NSFR terms. If the repos are treated unfavourably it will hurt market liquidity. Liquid markets are essential for banks' ability to fund themselves in a robust way. It is especially important that repos with HQLA should not be treated in the way currently proposed by the BCBS.

We understand that there could be potential problems with more speculative repo transactions. Therefore we propose that repos that can be regarded as HQLA repos, should have an RSF of 0% if the repo is six months or shorter. This could be expressed in §29 as:

(d) All loans which are fully secured with HQLA assets and have a maturity below six months.

For other repos the proposed regulation could be adequate.

SWEDISH BANKERS' ASSOCIATION

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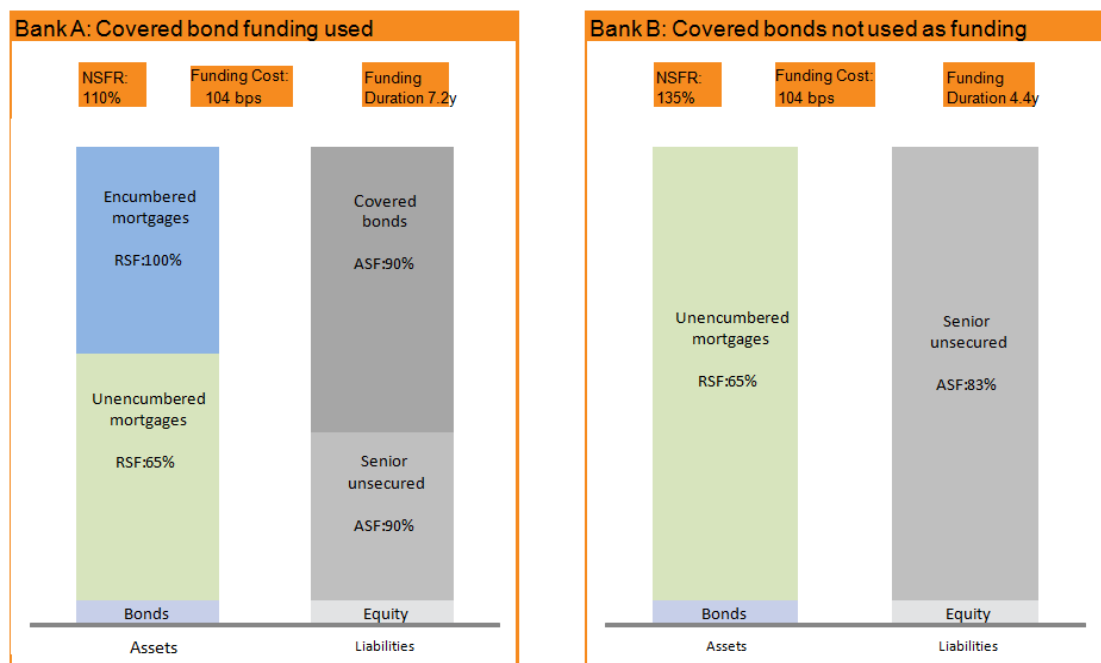
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## Appendix 1

### Difference between senior unsecured and covered bond funding from an NSFR perspective

In figure 1, bank A uses covered bonds while bank B does not. Both banks fund themselves in the capital market at an equal funding cost. Bank A cannot fully use covered bonds because of the need to have an over collateralization (OC). Both banks have a portion of equity that is invested in bonds.

Figure 1: Funding with covered bonds or senior unsecured



In both business models the funding cost is 104bps (as a spread over Stibor). The examples are constructed to reflect the rolling of bonds and loans so that shorter bonds will not have the same amount of ASF as the longer ones, etc.

The conclusion is that fulfilling the NSFR requirement will be easier with bank B's business model, despite bank B using funding of shorter maturity. Bank B will also be funded with instruments that have shown much less stability in difficult times than what is the case for covered bonds. The result is just the opposite of the intention of the NSFR. NSFR will give banks the incentive to use shorter funding and more unstable sources of funding. This will not lead to a more stable banking system and may even be a danger to financial stability in many countries. The damage may be particularly troublesome in countries with a well-developed secondary market for

covered bonds, such as Sweden and Denmark<sup>1</sup>. The regulation will incentivize banks to fund themselves with other, less stable, funding sources than covered bonds. This could lead to a shrinking market for covered bonds, which will also make the covered bonds less liquid. Consequently the whole system will be damaged.

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<sup>1</sup> BIS have analyzed the liquidity of government and covered bonds in Denmark before, during and after the 2008 financial crisis. The overall conclusion is that Danish covered bonds are as liquid as Danish government bonds, also in periods of market stress.  
<http://www.bis.org/publ/work392.htm>