

Comment to BCBS on Disclosure Standards for NSFR

Gordian Knot

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This paper is submitted in response to the Basel Committee on Banking Supervision's (BCBS) consultative document "Net Stable Funding Ratio disclosure standards", published December 2014.

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Purpose

This paper comments on the BCBS Consultative Document “Net Stable Funding Ratio disclosure standards” published in December 2014, for comments by 6th March 2015. Here we develop the disclosure standard required for the NSFR based on the “Alternative Approach to Measuring Stable Funding” proposal we made to the BCBS in their earlier request for comments, on 11th April 2014.

We appreciate this invitation from BCBS to comment on the Net Stable Funding Ratio (NSFR).

Executive Summary

In this response we make two main comments on the disclosure requirements:

1. We propose providing all analysts with the ability to apply their own behaviouralisation assumptions to both the liquidity of assets and the stability of liabilities by requiring banks to provide raw cash flow data. This would remove any possibility of criticism of the BCBS’s standard assumptions, allow analysts to create their own assumptions and to calculate “survival times” for each reporting institution using a range of assumptions (and exploring the sensitivity of those assumptions). This would be in addition to the BCBS standard assumptions.
2. We propose providing information on a cash flow basis, not a simplified balance sheet basis. This facilitates the analysis described above and removes the problem of dealing with all off balance sheet and contingent items such as derivatives and undrawn commitments. Adjustments for contingent positions are made by generating worst case cash flows and then behaviouralising them like all other cash flows based on types. No calculations are required to discount future cash flows and no mark-to-market or valuation processes are required.

The result is a significant increase in transparency and the ability to truly compare the structural liquidity of all types of reporting institution across borders.

Commentary

We agree with the BCBS’s goal of promoting funding stability and of the importance of having both a measure of immediate or “peak” need for funds, via the Liquidity Coverage Ratio (LCR) combined with a longer term structural measure of funding stability, measured by the Net Stable Funding Ratio (NSFR).

We propose implementing a process that removes any possibility of criticism of the BCBS’s behaviouralisation assumptions. Rather than requiring all analysis to be done using the BCBS assumptions we suggest providing analysts with raw data and encouraging them to develop their own assumptions. We consider that a free market in ideas is more valuable than a single centrally imposed standard, especially as this standard has no empirical basis and is no more than a series of assumptions.

1. Behaviouralisation Assumptions

The behaviouralisation assumptions proposed by the BCBS are:

1. Very simple based on type of asset or funding provider, and
2. Presented in broad time buckets.

As a consequence the BCBS process:

1. Does not enable any third party to add their own behaviouralisation assumptions,
2. Does not enable comparison of liquidity risk for different institutions across countries or currencies, and
3. Does not permit or allow the calculation of liquidity “survival times” using a range of assumptions.

Rather than critiquing the BCBS’s standard behaviouralisation assumptions, we propose that all reporting institutions publish the raw, unbehaviouralised data with increased granularity of type of cash flow, tenor, currency and legal entity, see Appendix 1. They already have this information as they need it both for their own management purposes and as the first stage of calculating the BCBS’s required output, so it is not a significant burden. This would allow third party analysts to apply their own behaviouralisation assumptions and would neuter all complaints about the BCBS’s own assumptions.

This process would enable each analyst to apply their own assumptions about funding stickiness and asset liquidity by type of asset and of funding provider, by currency and country (home country funding is regularly assumed to be stickier, but as has been shown recently even within a monetary union investors are fully aware of country risk), and by narrower time buckets to calculate a range of thoughtful measures of both structural liquidity and survival times. For simplicity a series of time buckets is required; we suggest that these should be as set out in Appendix 2.

Analysts could then compare each institution’s liquidity and survival times, using their own assumptions, compare how sensitive each is to changes in the assumptions and contrast them with the measure of liquidity using the standard BCBS assumptions.

This greater transparency is considered beneficial to both the stability of the overall financial system, and to the liquidity assessment of each institution. It also improves the BCBS’s position as it removes all possibility of the general complaints about the simplicity of the process, standardisation of assumptions and broad time buckets used by BCBS from the measurement of structural liquidity.

2. Cash Flow Disclosure Requirements

As opposed to using balance sheet data for calculating structural liquidity we propose using all cash flows for all contracts entered into by each reporting entity. This provides a complete liquidity picture as it includes all intermediate interest payments and coupons without any requirement to mark-to-market or to discount streams of future cash flows.

We recognise that contractual cashflows come in different flavours:

1. Totally known (e.g. term deposits will be repaid at maturity),
2. Expected (e.g. loan maturities from credit impaired customers, coupons on pass through or asset backed securities or option payments triggered by market factors)
3. Fully unknown (e.g. transactions driven by customer behaviour, such as drawdown of committed credit lines).

Consequently we need a consistent approach to defining cashflows before being able to assign them to time buckets and then behaviouralising them.

For expected cashflows an expected payment date must be applied based on independent market factors available (such as a prepayment assumption for ABS, or FX rates for the amount payable in FX options). Where no independent market factor is available, such as for the maturity date on credit impaired loans, the banks assumptions would be proposed by risk management, approved by management and be transparent to regulators. This is clearly a weakness of this approach as there is some flexibility in determining the underlying cash flows. However, it is preferable to the existing approach.

Where cashflows have an unknown due date they can either be assigned to a single time bucket (based on legal or expected due date) or can be assigned to a series of time buckets to accurately capture their profile.

Note that all cash flows must receive an assignment of 100% when all the time bucket allocations are added together as otherwise this process creates a form of fictional additional equity (when liabilities are not considered in full) and analysis of survivability periods will then make no sense.

Behaviouralisation is therefore a three stage process:

1. Identify the contractual due date of every related cash flow,
2. Apply an estimate for receipt or payment based on independent factors where possible and,
3. Apply behaviouralisation assumptions.

This process enables a full analysis of the cash flow profile and structural liquidity gap of each entity using a range of different assumptions as set out in “An Alternative Approach” our submission to the BCBS in April 2014 (attached as Appendix 3). A base case of unbehaviouralised cashflows is first calculated (see Figures 3 & 4 in Appendix 3) and then all cashflows can be behaviouralised into and across different buckets to create the behaviouralised structural asset-liability maturity gap as

shown in Figure 7. Analysts are free to weight the liquidity of assets and stability of funding sources themselves. Any reliance on Government and Central Bank funding is also transparent.

Summary

The combination of a short-term peak measure of need for liquidity (in the form of the LCR) and a structural measure of the asset-liability maturity gap, that enables calculation of the cost to close that gap, are powerful tools. Both benefit from standard assumptions about behaviouralisation, but the BCBS approach reduces transparency by applying its (quite simple) assumptions as a first step. These tools are more powerful if analysts are able to apply a range of assumptions (with a continuum of both time and cost) to cash flows in narrower time buckets at the end of the analysis as this enables both a meaningful cost to close and sensitivity analysis.

Thank you for allowing us the opportunity to comment on the NSFR.

Appendix 1: Proposed Cash Flow Types

Each cash flow is tagged with the following identifiers.

Cash Flow Identifiers:

- Amount
- Currency
- Cash inflow or outflow
- Time bucket (as detailed in Appendix 2)
- Legal entity this cash flow is held by

Cash Outflow (Liability) Type:

- Retail fixed term deposit;
 - in branch or
 - sourced from the internet
- Retail demand deposit
- Wholesale fixed term deposit
- Wholesale demand/operational deposit;
 - Type of wholesale depositor
 - Financial or non-Financial, Government or Central Bank
- Debt and equity capital securities issued;
 - seniority to include subordinate and capital
 - Intergroup funding, to which legal entity
- Minimum Distributable Amount restrictions
- Taxes due
- Salaries due (to tenor of each notice period), rents and other operating costs of running the business for the tenor of each contract
- Deposit offset/held as security against an extension of credit
- Derivative cash outflow
- Undrawn commitment, including undrawn amount of all overdrafts/uncommitted facilities
- Contingent outflow based on option contract

Cash Inflow (Asset) Type:

- Consumer loan interest or maturity payment
- Wholesale loan interest or maturity payment, credit rating where available or not rated
- Intergroup asset: due from which legal entity
- Type of investment security; Local Government, National Government, Supranational, Corporate or Financial or ABS, credit rating where available
- Derivative cash inflow, credit quality assessment consistent with IRB approach used for capital risk weightings or public rating if standardised capital approach is used

We would welcome the opportunity to work with BCBS to refine this list and develop a prototype process.

Appendix 2: Proposed Cash Flow Time Buckets

Cash Flow Time Buckets:

Next day

1-5 business days

5-10 business days

10-15 business days

15-30 business days

30-60 business days

60-90 business days

90-120 business days

120-180 business days

180-270 business days

270-360 business days

1-2 years

2-3 years

3-5 years

5-7 years

7-10 years

Greater than 10 years

Appendix 3: Reprinted from NSFR paper response 11th April 2014

An Alternative Approach

We suggest an alternative approach to a stable funding measure (as an addition to NSFR in the first instance, but as a possible longer term replacement) that is closer to the approach used by many banks already. This uses a “time value of liquidity” concept that looks at the cost of closing the asset-liability maturity gap using a range of behavioural assumptions for both assets and liabilities in addition to standard regulatory assumptions.

While the NSFR applies standardised liquidity risk factors to both assets and liabilities *before* doing the coverage calculation, we suggest that they should be applied *last* so that they can be varied by depositors, investors, bank management and regulators to create thoughtful sensitivity analysis which also ties back to solvency. This will be possible when combined with the proposed increased data transparency proposed above.

The process we propose is as follows:

1. Set out all the known/estimated cash flows of the bank on their scheduled payment date. This includes all derivatives and all option-like positions (undrawn facilities, puttable securities etc.) based on their actual legal status and worst case cash flows for the bank. This process avoids any cliff effects as assets and liabilities transition from greater than one year to less than one year (or any other arbitrary date) and places each cash flow on its expected date. We would envisage this to be done for a series of time buckets and for both asset and liability types, set by regulators, so that all banks report to the same standard. See Figure 1 below for cash outflows (mostly liabilities) and Figure 2 for cash inflows (mostly assets).

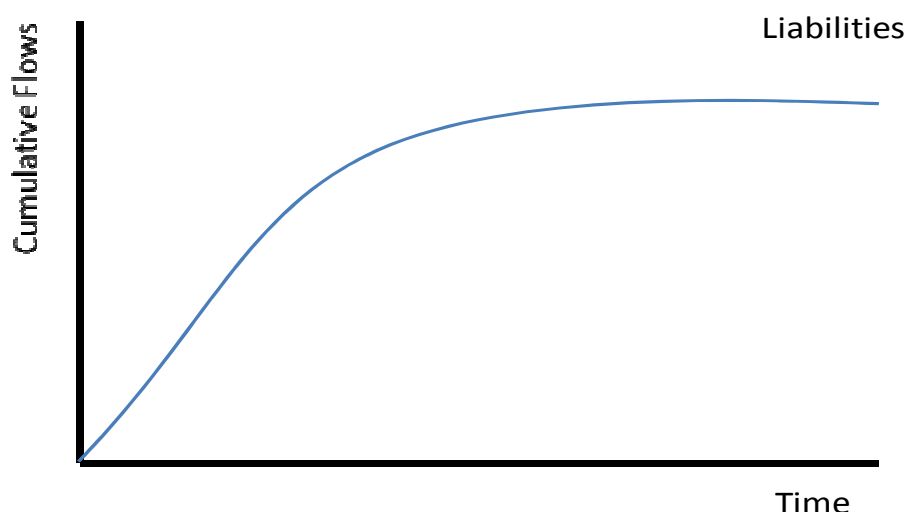


Figure 1

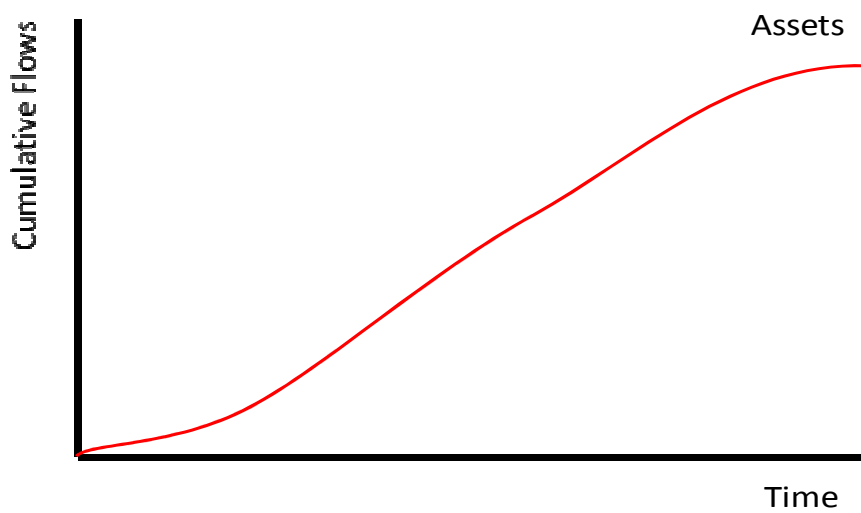


Figure 2

2. Show the known asset-liability maturity gap of the bank on this basis. See Figure 3 below.

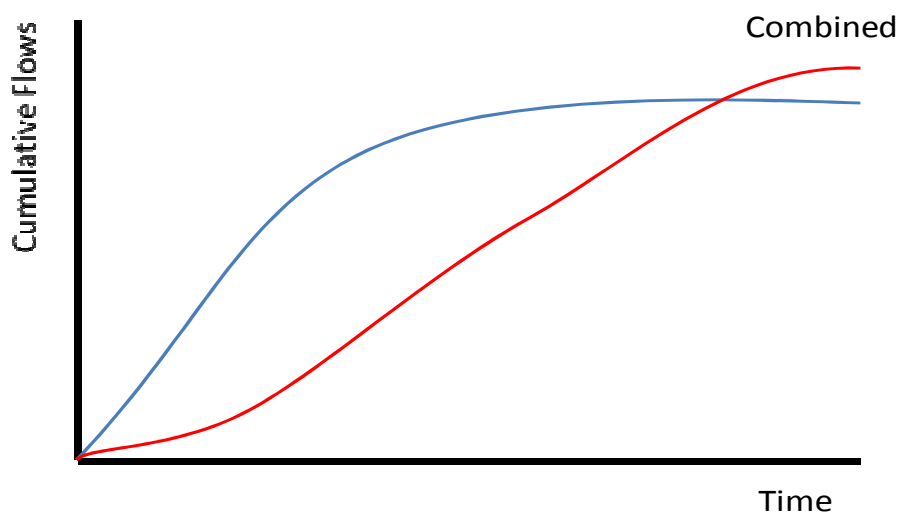


Figure 3

3. Calculate the cost to close the known asset-liability maturity gap using both:

- a) Private sector repo markets, and
- b) Central bank discount window facilities.

See Figure 4 below.

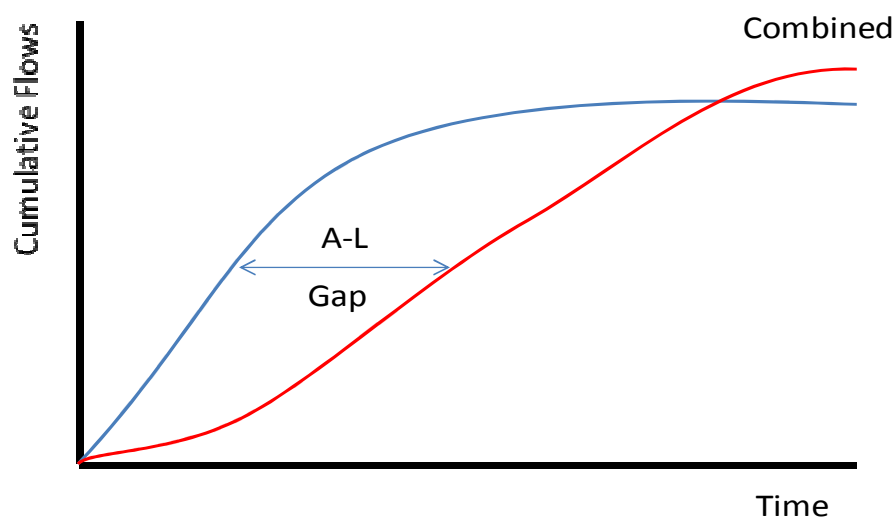


Figure 4

The cost and time frame to achieve liquidity from each asset class will generate a time that equity or collateral (they amount to the same) is exhausted. This is the “survival time” based on the prevailing cost of liquidity for the known asset-liability maturity gap. For assets such as loan pools for which a secondary market does not readily exist, this process includes the time and cost of selling or securitising and then either selling or repo-ing them (as explained above). For other highly specific illiquid assets (such as real estate, non-core business lines and long term investment positions) the time to sell and the discount assumed must be calculated based off recent market transactions. This is therefore an important measure of both structural liquidity and solvency.

4. Finally by adding behaviouralisation assumptions to each asset and liability type, step 2 above can be varied to recalculate the “survival time” from step 3, enabling sensitivity analysis to be performed independently by regulators, bank management and investors based on a range of their own behaviouralisation assumptions. See Figure 5 for behaviouralising assets, Figure 6 for behaviouralising liabilities and Figure 7 for the revised effect of closing the gap after full behaviouralisation assumptions have been included.

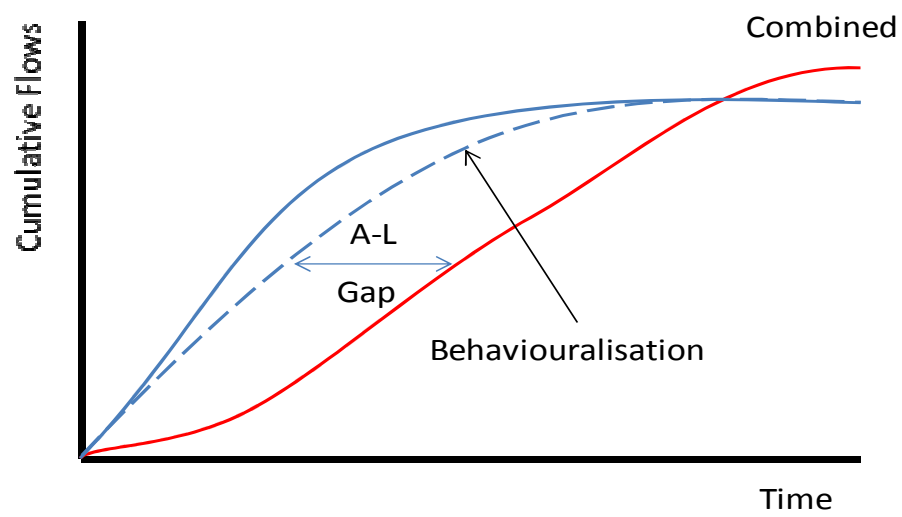


Figure 5

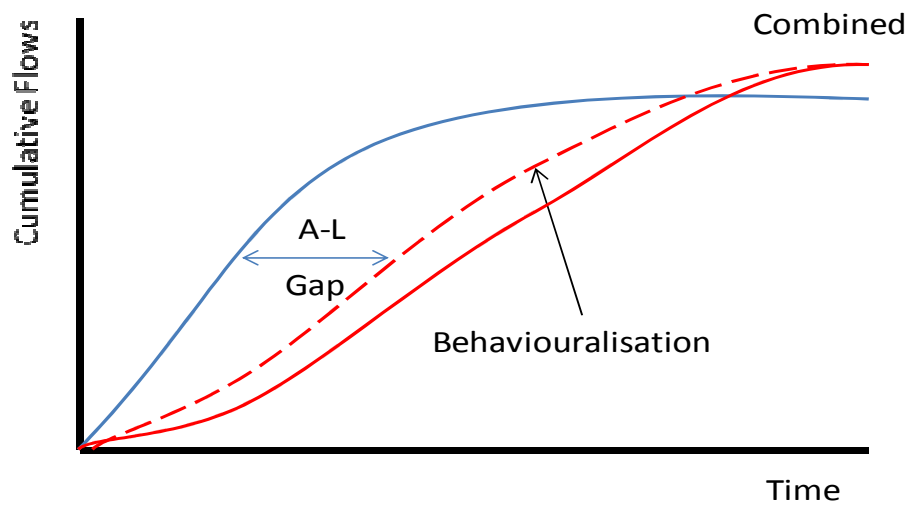


Figure 6

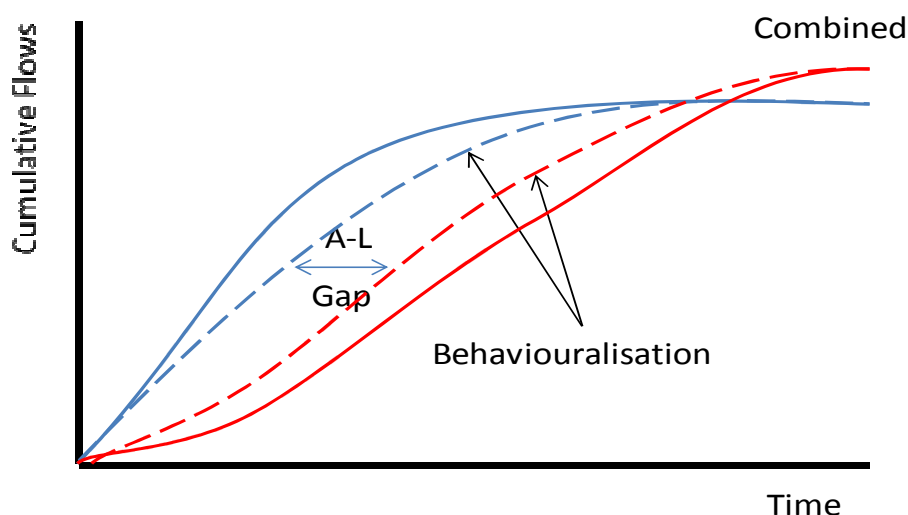


Figure 7

Why do we propose this approach?

Known maturities of liabilities are the only real measure of the stability of the liability side of the balance sheet.

The repo markets provide current cost of liquidity for each asset class enabling true “cost to close the asset-liability gap” analysis to be undertaken (step 3 above). Central bank discount window facilities provide worst case cost to close and are therefore an important backstop measure.

This approach allows market participants to analyse banks’ liquidity positions using known cash flows and then to add their own behaviouralisation assumptions as an alternative to standard regulatory assumptions. We envisage a transparency standard set by Basel that would require each bank to provide this data in a format manageable by investors. This would permit a continuum of risk factors by maturity to be applied, rather than the stair-step approach used at present. This process alone would provide a significant increase in transparency for regulators, investors and depositors in all banks.

We would be pleased to work with the BCBS to develop the technical standards for implementation of this more transparent alternative approach.