Secretariat of the Basel Committee on Banking Supervision  
Bank for International Settlements  
CH-4002 Basel  
Switzerland

By e-mail: baselcommittee@bis.org

April 11, 2014

Dear Sir or Madam:


I have attached to this letter our response to the consultation paper. This letter and the response have been prepared by S&P Ratings Services’ Financial Institutions ratings group.

I trust that the comments made therein are helpful and of relevance to the Basel Committee. S&P Ratings Services is committed to continuing its dialogue with the Basel Committee on Banking Supervision. Should you have any questions regarding the contents of this letter or the article please contact me or my colleagues listed in the article.

Yours faithfully

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Appendix 1

Below we provide Standard & Poor’s Ratings Services analytical opinion of the Basel Committee's revised proposal based on our understanding of the document.

Our main observations on the amended proposal are as follows:

- We consider it positive that the framework would for the first time introduce reasonably harmonized minimum requirements globally to monitor and potentially reduce funding mismatches.

- Unlike regulation on capital requirements, the NSFR and the associated new regulation on liquidity coverage ratios (LCR) both avoid the complexity and lack of transparency caused by the reliance on banks' internal models because they use a standardized approach to establish a minimum standard. At the same time, the framework leaves room for banking supervisors to distinguish themselves positively by setting prudent standards beyond the proposed minimum or to reflect jurisdiction or entity-specific circumstances, which may encourage firms to further develop internal models.

- We believe that globally harmonized funding and liquidity measures could significantly augment the analytical tools used by regulators and market participants, including Standard & Poor's, to make comparisons among banks and track changes in their funding and liquidity positions over time—assuming that there would be appropriate and timely disclosure. This would also strengthen market discipline, in our view.

- The revised proposal appears to us less stringent than the original proposal published in December 2010. We see a risk that its goal of establishing a minimum standard that extends to one year may not be achieved because the new proposal gives partial credit to wholesale funding sources that mature within six to 12 months.

- The proposal does not address refinancing risk for periods between 30 days and 12 months or time bands beyond one year.

- In order to ensure credibility of the new ratio, in a context of cross-border ring fencing, we believe it would be important to disclose restrictions to intra-group capital/funding flows.

- We see that market participants are demanding more information and metrics, and we consider the proposed timeline for implementation in January 2018 late. The committee could have partially addressed these concerns had it opted to phase in the regulations from an earlier starting point, similar to the implementation of the LCR.

- We observe some potential inconsistencies and gaps in the proposals and would welcome more disclosure from the Basel committee over the proposed assumptions and empirical studies from the financial market crisis that support these assumptions.
The Latest Modifications Relax The Original Proposal

In our view, the revised proposal is less stringent than the original one published in December 2010. The committee appears to have been motivated to relax the proposals by the political goal of ensuring lending to the “real economy,” which it says has been a consideration when determining a bank's stable funding needs. We believe a sound regulatory framework should primarily serve to maintain financial market stability because compromising on prudent principles to achieve political objectives, such as abundant credit supply, bears other risks such as excessive leverage, as the financial crisis has shown. Nevertheless, we believe that by strengthening regulation on funding and liquidity risks and trying to establish a reasonably harmonized minimum standard, the amended proposal could potentially address some of the weaknesses that we have observed in recent years. It will likely help banks comply and ease the transition considering that almost half of the global 222 banks that provided data to the Bank of International Settlements (BIS) failed to meet the originally proposed requirements as of year-end 2012.

We expect that traditional banks with a focus on retail and small and midsize enterprise (SME) customers will have fewest problems complying, unless their loan-to-deposit ratios are unusually high and well above 100%. Even at banks with a broadly balanced mix of retail and large corporate loan and deposit business, the proposed minimum standard should not require fundamental business model changes. Conversely, wholesale banks without a strong deposit base and trading in less liquid or lower quality assets could be required to either term out their funding, or reduce or change the composition of their trading inventory. The proposal would, however, still allow for sizable trading operations in what the proposal defines as high quality liquid assets (HQLA) with comparatively low long-term funding needs.

We nevertheless see a risk of negative rating actions if, as a result of the less stringent proposals on the liquidity coverage ratio (LCR) last year and further relaxation of the NSFR, banks that have reduced refinancing risk over the past few years were to abate their efforts and increase funding risk again. This could potentially affect the ratings on banks where our current funding and liquidity assessments are based on the expectation that banks will maintain improved risk profiles or continue to take corrective actions.

The Amended Proposal Could Potentially Reduce Refinancing Risk By Setting A Regulatory Floor

In our view, the proposed minimum standard for funding that supplements the new liquidity regulation is a positive step. It could potentially reduce the risk or at least the extent of funding-related banking crises considering that the NSFR is only one of several regulatory initiatives that have been, or will be, introduced over time. Previous banking regulations, such as Basel I and Basel II, have put much more emphasis on minimum capital requirements and, until today, there is no global regulatory framework for funding and liquidity in force. Therefore, we believe that implementing new regulation on funding and liquidity that would for the first time constrain banks' use of short-term funding sources
to finance longer-term or less liquid assets based on a reasonably harmonized global framework is a necessary component of regulatory initiatives currently under way.

Under the latest Basel proposal, funding sources that are expected to be reliable over one year should equal or exceed the amount of assets that need to be rolled over or could potentially not be monetized over the course of one year without significant expense. Industry participants have criticized the time horizon for being too long, and say that the regulation would ignore management actions. Although these arguments are valid in theory, we observe for example in Europe that funding market dislocations may last even longer, and that managements have sometimes responded only slowly to emerging risks, particularly if required actions put revenue goals and franchises at risk. Therefore, we typically look at a one-year time horizon for investment-grade rated entities as well because there is no telling how long a market disruption or economic downturn may persist.

We also believe that the committee's proposed methodology that assigns weighting factors to assets reflecting their presumed liquidity, and to liabilities reflecting their presumed stability is a plausible and pragmatic approach. Therefore, we have recently adopted a similar methodology to compute funding metrics, although with some modifications that help us to deal with disclosure gaps, to assess whether funding sources are appropriate for a bank's asset profile. The Basel proposal assigns all assets, liabilities, and off-balance-sheet exposures to different categories. Each category uses different adjustment factors that mainly consider contractual maturities, behavioral assumptions, type of counterparty, and asset quality. The carrying value of each item is then multiplied by its respective adjustment factor and the sum of the weighted amounts provides the total of required (assets, off-balance-sheet items) and available (liabilities) stable funding. For example, cash requires no stable funding, whereas loans to banks with a remaining maturity of one year or more require 100% stable funding. Conversely, capital and debt issued with a remaining maturity of one year or more are granted full stable funding credit, whereas wholesale market funding with a remaining maturity of less than one year receives less or no credit.

We consider it appropriate that the Basel committee prescribes a standardized approach to compute funding and liquidity metrics for all banks. This is very different from the minimum regulation on capital requirements, which allows banks to either use a standardized approach or internal models to prove compliance with minimum requirements. The banking industry has argued that a one-size-fits-all approach would not be appropriate and that internal models should be authorized given the diversity of business models. However, regulators' and market participants' experience with banks' internal models has not always been satisfactory. Moreover, although we see value in internal models, we do not believe that they are very effective in fostering market discipline. Their inherent complexity and lack of transparency do not facilitate independent analysis and cross-bank comparisons. We see them as useful complements to transparent, standardized assumptions, not as substitutes.

By setting a minimum standard, the Basel committee defines a floor that regulators--and with appropriate disclosure potentially also market participants--can more easily monitor.
In addition, regulators may decide to raise the bar, depending on their risk tolerance or to reflect jurisdiction or entity-specific circumstances. However, we acknowledge that metrics cannot capture all dimensions of funding and liquidity risks. We see, for example that the Basel proposal does not address refinancing risk for periods between 30 days and 12 months or time bands beyond one year, which gives rise to regulatory arbitrage. Therefore, we believe that banks continue to be strongly encouraged to develop or refine internal models to manage funding risks and help the supervisory process. At the same time, we consider it necessary that banks not only provide regular and detailed quantitative and qualitative disclosure on the composition of the proposed new regulatory funding and liquidity ratios, but also on risks that a single metric cannot embrace. Examples include:

- The size and composition of the bank’s wholesale funding.
- The bank's funding concentrations by creditors, tenor and funding instruments.
- The bank’s reliance on funding from nonresidents.
- Maturity mismatches in foreign currency.
- The bank’s reliance on central bank funding or other forms of official support.
- The potential constraints in transferring liquidity within the bank group.
- Other contractual and noncontractual contingencies.
- The liquidity of markets in which the bank operates and of its assets.
- Committed and irrevocable liquidity lines from third parties with a remaining maturity of one year or more.
- The expected amount and nature of the bank's asset encumbrance and its trend over time.
- The quality and composition of the bank's customer deposits and the credibility of deposit guarantee schemes in the countries where the bank operates.
- The granularity of the bank's customer loans and whether the relationship with its borrowers is transaction-based.
- The influence of the bank's ongoing interactions with the issuer's group and/or with the government on its funding and liquidity assessment.

Ample disclosure appropriate for the bank's complexity on these and other relevant factors could help strengthen market discipline and enhance management prudence. Without it, regulation can only go so far. Reducing transparency, for example by treating assets that are encumbered for central bank liquidity operations similar to unencumbered assets according to #27 of the NSFR proposal, could lead to factually incorrect disclosure, especially in situations of stress. We are unsure that such a disclosure gap will benefit market stability, as it could lead to market speculation that harmed even sound institutions in stressed market conditions.

We Observe Some Potential Inconsistencies And Gaps

We see a risk that the amended proposal may not achieve its goal of establishing a minimum standard that truly extends to one year because it gives partial credit to wholesale funding sources that mature within six to 12 months. We understand that this revision is in response to banks' complaints about cliff effects due to the asymmetric treatment of assets and wholesale funding. Under the former proposal, for example, a long-term loan that is
match-funded through the issuance of long-term debt at inception would have required additional stable funding at the time the remaining maturity of both falls below one year. Under the proposed revisions, banks would now be able to fund short-term loans up to one year with short-term wholesale funding with a remaining maturity of six months or more. This would be a funding relief for banks, as it pushes the cliff effect closer to the maturity date of the debt. However, it could potentially increase refinancing risks because banks may be incentivized to wait longer before they establish appropriate funding arrangements for loan renewals.

In our view, cliff effects within a prudent regulatory framework are inevitable because of the asymmetric risks on the asset and liability side. Unless client relationships are weak and solely transaction based, there is clearly an expectation from customers that their bank stands ready to renew loans to creditworthy clients. Banks that refuse to roll over loans may damage their reputation. This potentially greater franchise risk is also underpinned by political moves to refocus banks’ business activities toward client-related banking that supports the real economy and deemphasizes potentially less franchise-sensitive activities, such as sales and trading. In addition, we see that in a crisis there is a risk that loans need to be renewed, as many borrowers cannot repay their loans. Conversely, banks do not have the option not to repay debt when investors refuse to buy their debt or customers opt to withdraw their money.

Instead of introducing new time buckets of up to six months and six to 12 months for a metric that is supposed to capture a one-year time horizon, the committee could have considered introducing metrics and minimum requirements for different time periods below one year. This could potentially have avoided giving 50% stable funding credit to particularly confidence-sensitive funding sources that mature within one year, or treating assets that are fully encumbered for periods of less than one year as if they were partially unencumbered. Different time buckets could have been a clearer solution that would also have allowed for monitoring of funding risks over different time horizons. We see that the NSFR reporting template captures five different time buckets of up to three months, three to six months, six to nine months, nine to 12 months, and above 12 months, but it is unclear how this information will be used. We believe that this more granular information would be useful for analytical purposes and should be disclosed as well.

The Basel Committee Should Disclose Its Considerations

The new proposal would lower a bank's stable funding needs for loans to nonbanks with a remaining maturity above one year to 50%-85% from 65%-100%, and for loans with a remaining maturity of less than one year to 50% from 50%-85%. Data released by the European Central Bank (ECB) show, for example, that within the euro area, the total of loans to nonbanks excluding governments declined by only 5.8% over more than two years between the peak in September 2011 and the trough in February 2014. In addition, we observe that none of the 50 largest rated Western European banks were able to reduce customer loans by more than 10% without significant government support in 2011 or 2012. The median decline in customer loans was about 5% for those banks that were able to
reduce loan portfolios in both years. During the same period, wholesale market funding dried up and required the ECB to grant extraordinary long-term liquidity lines to banks, which increased the ECB’s balance sheet to new record highs. This experience also puts into question whether the Basel committee's decision to propose a further relaxation on stable funding needs for customer loans is appropriate.

Equally, we would be interested to learn whether the Basel committee's assumptions about the stability of deposits are underpinned by empirical evidence. Under the new proposal, the factors for available stable funding for deposits from retail clients and SME customers would further increase to 90%-95% from 80%-90%. Conversely, the proposal assumes that only 50% of corporate deposits are stable. This raises questions about the absolute and relative stability of customer deposits and how the committee considers the quality of deposits. We and others, including for example IMF in a study, have observed that, under stress, deposit outflows can be much higher than 5% or 10%, even within a few weeks. Recent examples include Austria-based BAWAG in 2006, U.K.-based Northern Rock in 2007, Latvia-based Parex Bank in 2008, Greece-based National Bank of Greece, and Spain-based Bankia in 2011. Even in Germany, where customer deposit protection is well above the legal minimum, the government saw the need to state publicly that it would guarantee all customer deposits to avoid the risk of bank runs after the media had reported on deposit withdrawals at Northern Rock. The NSFR refers to the definition of deposits under the LCR, which in turn asks supervisory authorities to develop additional buckets of potentially less stable deposits. It therefore remains to be seen how the greater risk of outflows of less stable deposits as mentioned in #79 of the LCR framework or as result of high depositor concentration, and the potentially greater stability of for example insured corporate deposits will be reflected in jurisdiction specific run-off rates.

We believe that greater relaxation on loans and deposits was not really necessary for lending and deposit-taking banks without large capital market activities. This is because these banks would likely have met the NSFR requirements either with or without moderate changes to their funding strategies under the former draft. We would also caution against the continuous practice of giving preferential treatment to mortgage loans under regulatory funding and capital requirements, considering the role that mortgage lending has historically played in the emergence of banking crises.

The Basel Funding Ratio Is A Positive Step, But Implementation Is Slow

From a credit perspective, we believe that the NSFR framework and the principles the paper sets out could significantly strengthen banks' funding positions and the supervisory review process. This, in turn, could reduce the risk of idiosyncratic or systemic stress or at least the negative implications of stress for the economy. We also believe that globally harmonized funding measures could significantly augment the analytical tools used by market participants, including Standard & Poor's, to make comparisons among banks and track changes in their funding positions over time—assuming that there would be appropriate and timely disclosure. We expect smaller, deposit-funded retail banks to find it
easier to comply with more stringent requirements than larger wholesale-funded institutions with extensive trading operations. We believe that the latter will likely need to make more significant changes to their balance-sheet structures or business models, possibly because the new liquidity and funding requirements could make holding illiquid assets less attractive or because of limited long-term wholesale funding capacity. We see that market participants are demanding more information and metrics and consider the proposed timeline for implementation in January 2018 late. A number of banks already report the new ratio, although regulations are not final yet (see table 1). In our view, the committee could have partially addressed these concerns had it opted for a phase-in approach that had started earlier, similar to the implementation of the LCR.

Table 1

<table>
<thead>
<tr>
<th>Bank Name</th>
<th>Net Stable Funding Ratio 2013 (%)</th>
</tr>
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<tbody>
<tr>
<td>ABN AMRO Bank N.V.</td>
<td>105</td>
</tr>
<tr>
<td>Barclays Bank PLC</td>
<td>110</td>
</tr>
<tr>
<td>Rabobank Nederland N.V.</td>
<td>114</td>
</tr>
<tr>
<td>Credit Suisse AG</td>
<td>&gt;100</td>
</tr>
<tr>
<td>Erste Group Bank AG</td>
<td>&gt;100*</td>
</tr>
<tr>
<td>KBC Groep N.V.</td>
<td>111</td>
</tr>
<tr>
<td>Royal Bank of Scotland PLC</td>
<td>122</td>
</tr>
<tr>
<td>Standard Chartered Bank</td>
<td>110-120</td>
</tr>
<tr>
<td>Swedbank AB</td>
<td>97</td>
</tr>
<tr>
<td>UBS AG</td>
<td>109</td>
</tr>
</tbody>
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*As of third quarter 2013.

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