EUROPEAN COMMISSION
Directorate-General for Financial Stability, Financial Services and Capital Markets Union

DG FISMA CONSULTATION PAPER

ON FURTHER CONSIDERATIONS FOR THE IMPLEMENTATION OF THE NSFR IN THE EU

Disclaimer

This document is a working document of the Commission services for consultation and does not prejudge the final decision that the Commission may take.

The views reflected on this consultation paper provide an indication on the approach the Commission services may take but do not constitute a final policy position or a formal proposal by the European Commission.

The responses to this consultation paper will provide important guidance to the Commission when preparing, if considered appropriate, a formal Commission proposal

Introduction

During the financial crisis, banks made use of excessive amounts of short-term wholesale funding to finance their long term activities. When short-term funding became unavailable, banks were forced to 'fire sell' assets, triggering a downward spiral in prices and harming confidence in the financial sector, with the ultimate consequence of driving a number of banks into insolvency.

To address these issues, promote funding stability and limit over-reliance on short-term wholesale funding, the Basel Committee on Banking Supervision (BCBS) introduced in October 2014 the Net Stable Funding Ratio (NSFR) as a new liquidity requirement (the standards contain a limited review clause on specific aspects of the treatment of derivatives transactions under the NSFR). The NSFR measures the assumed degree of stability of liabilities (expressed as an available stable funding factor - ASF) and the liquidity of assets (expressed as a required stable funding factor - RSF), over a one-year horizon: NSFR= ASF/RSF ≥ 100%. As a consequence banks need to finance their long term activities with a stable source of funding in order to respect the NSFR requirement. The NSFR is intended to regulate risks not currently covered by Pillar 1 requirements. It also complements the Liquidity Coverage Ratio (LCR), which is a stress liquidity ratio on a 30-day horizon that entered into force in the EU in October 2015.

At the European level, Regulation (EU) No 575/2013 (Capital Requirement Regulation, hereafter "CRR") introduced a reporting requirement for the NSFR without setting out more detailed requirements. It also required the European Banking Authority (EBA) to analyse the BCBS NSFR standard further in a European context. Pursuant to Article 510 of the CRR, the EBA published in December 2015 a report on whether and how it would be appropriate to ensure that institutions use stable sources of funding[1], supporting the introduction of the BCBS NSFR at European level but with some European specificities regarding its calibration.

In its Communication “Towards the completion of the Banking Union” of November 2015[2], the Commission announced that further risk reduction measures were needed, in particular measures to assure stable bank funding, and announced its intention to legislate on this issue.

In this context, Commission services are currently analysing the conclusions of the EBA report as well as evaluating the responses from the recent Call for Evidence launched in September 2015 where many respondents expressed concerns on the fact that the NSFR could unduly constrain banks' ability to finance the real economy. They therefore called for a more nuanced treatment of specific business models and of some specific transactions, in particular market activities. A too punitive treatment of market activities, in particular derivative transactions and short term repo and reverse repo, could indeed limit banks’ access to some funding sources and increase the constraints on banks’ funding to respect the NSFR requirement, leading to a decrease of funding available to finance the real economy. Particular attention is paid by the Commission as to whether the calibration of the RSF and ASF factors in the BCBS standards would not unduly penalise certain banking activities in the EU and would not hinder the financing of the EU economy.

To complement the analysis in the EBA report, the responses to the Call for Evidence and to provide a basis for the announced legislative changes, the Commissions services are launching this public consultation to gather stakeholders’ views on the treatment of some specific aspects of the NSFR. Stakeholders are invited to send their contributions to this public consultation by 24 June 2016 to this functional mailbox: FISMA-CONSULT-NSFR@ec.europa.eu.

The Commission services invite stakeholders to provide specific and short answers, setting out a precise description of the concerns raised by the application of the BCBS standard, a detailed explanation of the rationale of the preferred option, robust arguments supporting

[1] "EBA report on Net Stable Funding Requirements under Article 510 of the CRR", EBA, December 2015, https://www.eba.europa.eu/documents/10180/983359/EBA-Op-2015-22+NSFR+Report.pdf

[2] Communication from the Commission to the European Parliament, the Council, the European Central Bank, the European Economic and Social Committee and the Committee of the Regions "Towards the completion of the Banking Union", 24 November 2015

the preferred option and a qualitative and quantitative assessment of the expected impact on the European economy (if possible compared to the impact of the BCBS treatment).

Potential adjustments resulting from complying with the NSFR

When implementing the BCBS NSFR standards, close attention will be paid to the diversity of banks' business models and will aim at limiting any excessive impact on bank lending. The EBA report on the NSFR standards does not envisage any detrimental effect of the BCBS NSFR standards on bank lending, financial asset markets or trading book positions in banks, but acknowledges that there was only limited data available. Although stakeholders have already expressed their views on the NSFR standards in the build-up to the EBA report (public hearing preceding the publication) and more broadly through the Commission's Call for evidence, these views were generally not substantiated. In particular, stakeholders mentioned the impact on their market activities; on covered bond issuances; and on trade finance activities but also on the internal liquidity pricing or on the price of funding.

1. *In light of previous consultations, could you describe more specifically, if appropriate, the specific activities, transactions and business models where you have evidence that the implementation of the NSFR could have an excessive impact or important unintended consequences?*
2. *If a respondent is a bank, could you please quantify the level of your expected shortfall of stable funding, the changes to the composition of your balance sheet that may result from meeting the NSFR and what the impact of these changes may be on the European economy?*

Derivatives transactions

In the BCBS NSFR Standard, 'NSFR derivatives assets' are defined as the positive replacement cost for derivative contracts offset by cash variation margins received, that meet the conditions specified in paragraph 25 of the BCBS leverage framework[3] (§34 and 35 of the BCBS NSFR standard). 'NSFR derivatives liabilities' are defined as the negative replacement cost for derivative contracts offset by all variation margin posted (§19 and 20 of the BCBS NSFR standard). If NSFR derivatives assets are greater than NSFR derivatives liabilities, the difference is subject to a 100% RSF factor (§25(c) of the BCBS NSFR standard). If NSFR derivatives liabilities are greater than NSFR derivatives assets, the difference is subject to a 0% ASF factor (§43(b) of the BCBS NSFR standard).

Initial margins are posted on top of that (excluding initial margins posted on behalf of a customer) and contributions to the default fund of a central counterparty (CCP) are subject to an 85% RSF factor (§42(a) of the BCBS NSFR standard).

Finally, gross derivatives liabilities are subject to a 20% RSF factor (§43(d) of the BCBS NSFR standard). As explained in the EBA NSFR report (p.166), this RSF aims at capturing "*to some extent, future funding risks arising from negative mark-to-market movements that ultimately result in net requirements to post collateral. […] This add-on allows covering this potential unfavourable evolution over one year (be they due to losses on derivative contracts or increases in the proportion of derivative liabilities where the bank is asked to post margins)*". The RSF therefore seeks to capture an additional funding risk related to the potential increase of the derivatives liabilities over a year, implying that more margins would have to be posted (for uncollateralised derivatives this funding risk is potentially more material but more hypothetical since it is conditional in the event that the counterparty requires the institution to post margin within a year) and that other derivative cash-flows have to be paid to the counterparty. The RSF then requires that 20% of the current gross derivatives liabilities be stably-funded on a one-year horizon.

[3] "Basel III leverage ratio framework and disclosure requirements", BCBS, January 2014, http://www.bis.org/publ/bcbs270.pdf

There is a risk that the 20% RSF on gross derivatives liabilities could lack risk-sensitivity since it does not take into account the dynamics of the derivatives portfolio over one year and the evolution of the relationships between derivatives assets and liabilities for offsetting portfolios. As a result, it could under-estimate the future funding risk in some situations (e.g. it would produce a small RSF when total derivatives liabilities are close to zero) and over-estimates it in others (e.g. large, offsetting derivatives portfolios of major market-makers will be particularly impacted).

To better capture this funding risk, it is currently assessed whether it is appropriate to readjust (e.g. applied as a floor and not as an add-on) or if other measures could be provided for, particularly the new Standardised Approach for Counterparty Credit Risk ('SA-CCR')[4], which has not been implemented in the EU yet. Indeed, the potential future exposure (PFE) component of the SA-CCR captures the change in value of derivative portfolios over a given time horizon (while this change represents an increase in the value of the derivative portfolios in the counterparty credit risk framework, it could also represent a decrease since SA-CCR was calibrated using at-the-money volatilities). This would add little computational burdens to the institutions if the SA-CCR was used for the purpose of the Leverage Ratio calculation.

3. *In light of previous consultations, could you provide substantiated evidence about possible issues caused by the application of the BCBS NSFR standard to derivative transactions at European level and which have not been taken into account at Basel level? If yes, what alternative treatment would you propose for NSFR calculation purposes to deal with the funding needs arising from derivatives transactions? If possible, please provide the impact on your institution of the alternative treatment you propose (as compared to the BCBS standards).*
4. *More specifically, regarding the 20% RSF factor applicable to gross derivatives liabilities, do you think it would be possible and appropriate to develop a more risk-sensitive approach that would take better account of the funding risk arising from banks' derivative activities over a one-year horizon? In that case, what could be this approach? Do you think that the use of the SA-CRR could provide an appropriate measure? If possible, please provide the impact on your institution of the alternative treatment you propose (as compared to the BCBS standards).*
5. *If you propose special treatment for specific activities (eg hedging instruments, clients clearing...), how would you define these activities?*

<u>Short term transactions with financial institutions</u>

The NSFR introduces an asymmetric treatment between short term (less than 6 months) borrowing from and lending to financial institutions. The funding received from financial institutions on a short term basis, including repo transactions, are not recognized as stable funding with a 0% ASF (§25(a) of the BCBS NSFR standard) while short term lending to financial institutions, including reverse repos, are subject to a 10% or 15% RSF factor, depending on the liquidity value of the collateral received (§38 and 39 of the BCBS NSFR standard). Securities financing transactions with a single counterparty can be measured net provided the conditions of the §33(i) of the BCBS leverage framework are met (§33 of the BCBS NSFR standard).

6. *In light of previous consultations, could you provide substantiated evidence about possible issues caused by the application of the BCBS NSFR standard to short term transactions with financial institutions at European level and which have not been taken into account at Basel level? If yes, what alternative treatment would you propose for NSFR calculation purposes to deal with the funding needs arising from short-term*

[4] "The standardised approach for measuring counterparty credit risk exposures", BCBS, April 2014, http://www.bis.org/publ/bcbs279.pdf

transactions with financial institutions? If possible, please provide the impact on your institution of the alternative treatment you propose (as compared to the BCBS standards).

7. *If you propose special treatment for specific activities (e.g. client's short facilitations activities, prime brokerage businesses…), how would you define these activities?*

Application of the proportionality principle

The BCBS NSFR standard applies to internationally active banks on a consolidated basis but may be used for other banks or a subset of entities of internationally active banks (§50 of the BCBS NSFR standard).

For the implementation of the LCR at the European level, the decision was made to apply the LCR to all credit institutions both on a consolidated and individual basis. Flexibility and proportionality was added through the introduction of an intragroup preferential treatment, the specific treatment of certain business models and the possibility of granting waivers on an individual basis subject to competent authorities' decision.

8. *What do you believe the appropriate level of application of the NSFR to be? Is there scope to make the NSFR requirements more proportionate and, if so, on the basis of what criteria?*

9. *In particular, what criteria could be used to define institutions with a "low liquidity risk profile"? What simplified metrics (e.g. core funding ratio close to loans to deposits + capital) could be used to identify these institutions? Should certain institutions be completely exempted from the NSFR and on what basis?*