EUROPEAN CENTRAL BANK

EUROSYSTEM

Eurosystem contribution

to the European Commission's DG FISMA consultation paper on further considerations for the implementation of the net stable funding ratio in the European Union

General remarks

The financial crisis demonstrated that regulatory capital requirements alone are insufficient to ensure the resilience of the banking system. In particular, excessive maturity mismatch and funding risks from on and off-balance-sheet activities made banks vulnerable to shocks which also affected their solvency. As a consequence, the Basel Committee on Banking Supervision (BCBS) agreed to implement the net stable funding ratio (NSFR) as part of the much-needed and far-reaching reform of the international regulatory framework. The NSFR is one of a number of key items on the post-crisis agenda that are yet to be fully implemented and will contribute to financial stability by making the banking sector more resilient through an improvement in banks' funding profiles.[1]

Specific remarks

A Potential adjustments resulting from compliance with the NSFR

A.1 The available evidence for European banks does not suggest an excessive impact of the NSFR for the majority of banks.

As shown in the European Banking Authority (EBA)'s monitoring reports, European banks – both Group 1 and Group 2 banks – have "frontloaded" the NSFR and, on average, already meet the NSFR since December 2013.[2] Based on June 2015 data, the average NSFR for Group 1 and Group 2 banks is 104% and 111% respectively. While the majority of banks already meet an NSFR minimum of 100%, the overall NSFR shortfall in June 2015 amounted to €340 billion. As these figures are based on the BCBS calibration, the impact of an NSFR requirement should take into consideration other elements that may materially reduce the shortfall before further revising the NSFR in the EU context. For example, elements

1 See "Basel III and recourse to Eurosystem monetary policy operations", *Occasional Paper Series*, No 171, ECB, April 2016.

2 Group 1 banks are defined as internationally active banks that have Tier 1 capital of more than €3 billion and Group 2 banks comprise all other banks. The results of the EBA monitoring exercise are available on the EBA's website.

with a potentially significant impact on the NSFR are: (i) differences in the EU definition of high-quality liquid assets (HQLA), such as the inclusion of covered bonds as Level 1 assets and a broader set of eligible asset-backed securities under the liquidity coverage ratio (LCR), which would materially ease the NSFR requirement;[3] and (ii) the minimum requirement for own funds and eligible liabilities (MREL) which requires banks to issue long-term debt.

Moreover, the EBA recently published a detailed report on the NSFR, in which it did not find strong statistical support for a detrimental effect of the NSFR on bank lending, including to small and medium-sized enterprises.

It should be recalled, however, that, as pointed out by the EBA, a significant NSFR shortfall is concentrated in a few large banks, where, in some cases, significant and difficult adjustments could be expected.

Nevertheless, as discussed in the next sections, there are deficiencies with respect to the treatment of derivatives and securities financing transactions (SFTs) which should be acknowledged and monitored to ensure that there are no unintended consequences, both from a prudential and a market functioning perspective, and in particular for institutions with significant activities of this kind. Moreover, close monitoring is warranted for specific pass-through business models that may be particularly impacted by the NSFR requirements, such as trade finance and factoring.[4]

B Treatment of derivatives

B.1 While the treatment of derivatives in the current NSFR rules does not appear to raise issues, there are methodological deficiencies that need to be acknowledged.[5]

Despite the limited evidence, we would like to express our views on two specific areas related to the treatment of derivatives under the NSFR. The first area relates to the **collateral received, which can reduce derivative assets.** Market participants have voiced concerns that the treatment of collateral received as variation margin may be overly restrictive as it excludes in particular Level 1 HQLA received as variation margin. While the market liquidity for Level 1 HQLA is assumed to be comparable to cash under the LCR, the NSFR considers that HQLA have to be funded with stable resources and are therefore subject to a positive NSFR factor. As opposed to cash, which can indeed be seen as a form of pre-settlement of the derivative asset, Level 1 HQLA would have to be monetised first if the bank intends

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3 The underlying assumption is that the treatment of HQLA under the EU NSFR will be implemented in a manner consistent with the EU LCR.

4 See also the "EBA Report on Net Stable Funding Requirements under Article 510 of the CRR", published on 15 December 2015, for the proposed changes to the Basel rules to account for the European specificities of such business models.

5 The Annex provides an analytical assessment generally supporting the BCBS provisions on the main design features.

to cover its funding needs, e.g. via secured financing transactions. In turn, re-using securities received as collateral could create additional maturity mismatches and also increases the overall stable funding requirement of the institution. From this perspective, **the current treatment is therefore consistent with the overall design of the NSFR.**

The recognition of cash collateral received as variation margin for the NSFR follows similar rules to those adopted for the leverage ratio, which are limited to cash collateral only.[6] Recognised variation margin received reduces the derivative assets, reflecting that this cash is a form of pre-settlement of the derivative asset position. **The current treatment thus aims to ensure consistency between the leverage ratio and the NSFR, thereby reducing the complexity of the regulatory framework and limiting the operational burden on banks when calculating the NSFR. Nevertheless, the Commission should assess whether, considering the different purposes of the leverage ratio and the NSFR, the treatment of Level 1 assets used as variation margin should be fully aligned in the two bodies of legislation. Any changes to the currently proposed treatment should however be preceded by a quantitative impact study.**

The second area relates to the NSFR requirement for gross derivative liabilities. The current BCBS proposal on this could be further improved. The current rule assumes that the 20% factor applied to gross derivative liabilities is an estimation of the future market and counterparty exposure. However, the gross derivative liabilities represent the replacement cost of the contract, i.e. its negative mark-to-market value. The future counterparty credit risk – which arises from adverse market movements and which may need to be funded – depends, however, on factors other than the mark-to-market value of the contract, such as the notional amount, maturity, type and volatility of the asset underlying the derivative contract. As such, the 20% factor may underestimate potential future exposure, as large notional long-maturity transactions can have at certain points in time minimal mark-to-market values, while being subject to very large potential future exposures.

We see benefits in the introduction of a more sensitive measure of potential future derivative exposure in the NSFR, such as the potential future exposure (PFE) component of the BCBS standardised approach for measuring counterparty credit risk (SA-CCR), adopted in 2014. The PFE concept is currently being applied in multiple BCBS standards, for example to measure derivative exposure for leverage ratio purposes.[7] However, replacing the 20% with the PFE measure leads to a material deviation from the Basel Committee agreement and may increase available funding sources, especially for banks with large derivative books. Therefore, the ECB urges further analysis to assess the impact of switching to the PFE or other more suitable measures and whether there is a need to take into consideration less than a full PFE measure. An implementation of the PFE measure should however be

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6 Additional conditions that need to be met are: (i) cash received as collateral is not segregated and can be re-used; and (ii) a single master netting agreement is in place with a daily exchange of fully extinguishing variation margins.

7 See the BCBS consultative document on "Revisions to the Basel III leverage ratio framework", issued for comments by 6 July 2016.

preceded by a quantitative impact study undertaken by the EBA, given that this option was never discussed at the BCBS level for the NSFR and therefore its impact on the ratio is at the current stage unknown. The European Commission, taking into consideration the EBA's recommendations, could supplement the NSFR legislation at a later stage.

Finally, the current provisions regarding the netting mechanism underlying the measurement of derivative exposure in the NSFR may raise some prudential issues. The Annex analyses in more detail several methodological issues.

C Securities financing transactions

C.1 The final BCBS NSFR standards adopted in October 2014 introduced an asymmetry in the treatment of short-term secured financing transactions. A reverse repurchase agreement with a maturity of less than six months would be subject to a stable funding requirement of 10% or 15% depending on the quality of the collateral received, while a repurchase transaction of a comparable maturity would not provide any stable funding to the transacting institution.

This treatment was introduced to prevent institutions from over-relying on short-term wholesale funding to meet their funding needs. The financial crisis showed that this type of funding can be extremely volatile and can very quickly disappear in times of market or idiosyncratic stress. In order to prevent such excessive reliance on short-term wholesale funding, the NSFR therefore introduces a stable funding requirement for short-dated SFTs. Moreover, the asymmetric treatment of short-dated repos and reverse repos reflects that banks, during crises, often need to roll over lending owing to franchise concerns, even as their matched funding is curtailed.

Market participants have voiced concerns about the potential impact of the NSFR on repo markets.[8] The available evidence from the ECB's money market survey and the International Capital Market Association (ICMA) has so far not supported this view. Repo market volume has remained resilient despite the "frontloading" of banks' NSFR.[9]

Moreover, the ECB takes the opportunity of this consultation to raise the attention of the European Commission to a loophole that was identified recently during the BCBS discussions on the treatment of re-used collateral under the NSFR. While own assets used as collateral are considered as encumbered under the current NSFR rules and are therefore subject to a stable funding requirement according to the

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8 See "Impact of the Net Stable Funding Ratio on Repo and Collateral Markets", ICMA Repo and Collateral Council, 23 March 2016.

9 See "European Repo Market Survey No 30", ICMA, and "ECB Money Market Survey", 30 April 2015.

maturity of the encumbrance, collateral received and re-used as collateral, and which does not appear on the institution's balance sheet, would not be subject to any encumbrance, i.e. would not receive an RSF (required stable funding) factor. This loophole thus allows institutions to improve the NSFR without adequately addressing short-term funding risks.[10] The ECB therefore invites the Commission to consider how this loophole could be closed, also taking into account the outcome of the BCBS discussions on this issue. The ECB also invites the Commission to accompany this with an assessment of any unintended consequences of the closing of the loophole for the smooth functioning of the securities financing markets.

D Application of the proportionality principle

D.1 The ECB concurs with the finding of the EBA report on the NSFR that there is no clear correlation between the size of institutions and their level of compliance with the NSFR.

Based on information already available at this stage, the ECB observes also that the level of compliance is already generally high and, in most cases, well above the minimum 100% level for most of the smaller institutions. Therefore, the case for a different requirement for smaller institutions based on the size of their balance sheet cannot be supported on the basis of the available evidence.

In line with the supervisory principles highlighted in the ECB's "Guide to banking supervision"[11], supervision needs to be homogeneous within the Single Supervisory Mechanism (SSM) and consistent with the Single Market. It is therefore important that all entities belonging to significant groups as per Article 6(4) of the SSM Regulation[12] are subject to the same stable funding requirements. We do not believe that differentiated risk metrics applied to different institutions that belong to the same group would produce significant relief from compliance costs at the consolidated level. Conversely, a fragmented or partial implementation of internationally agreed standards on stable funding requirements would be detrimental to the regulatory level playing field in the EU.

The ECB also acknowledges the need for a proportionate approach of regulation and supervision. The ECB considers that stable funding reporting requirements should reflect this principle of proportionality and should be implemented in a differentiated manner across institutions. In this respect, the frequency and granularity of the reports should be consistent with the riskiness of each institution. From this perspective, indicators such as the funding risk as measured by the NSFR and the outcome of the Supervisory Review and Evaluation Process (SREP) could

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10 Banks can increase their NSFR by raising additional long-term funding secured by collateral received on a short-term basis. However, this creates funding risk given that the collateral may need to be returned before the repo matures.

11 See the ECB's "Guide to banking supervision", November 2014.

12 Council Regulation (EU) No 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions.

be taken into account, as well as the volatility of the available stable funding (ASF) and required stable funding (RSF) over time for each institution.

With regard to whether specific activities or business models may require a differentiated treatment under the NSFR, the ECB supports the EBA recommendation to exempt from the NSFR central counterparties (CCPs) which hold a banking licence and which act merely as intermediaries, having due regard for their business model, considering that these institutions do not collect retail deposits and have a generally matched funding profile. The imposition of a stable funding requirement as developed by the Basel Committee may not be the most appropriate tool to capture the funding risk inherent in CCPs' activities.

Annex

Derivatives

The 0% ASF factor applied to NSFR derivative liabilities net of NSFR assets (where NSFR derivative liabilities are greater than NSFR derivative assets) and the 100% RSF factor applied to net NSFR derivative assets (where NSFR derivative assets are greater than NSFR derivative liabilities) appear appropriate, for the reasons explained in the next paragraph.

Derivative liabilities are similar to short-term liabilities and, as such, they should not contribute at all in providing stable funding, irrespective of whether they are computed net of derivative liabilities or not. Assessing the merits of a 100% RSF applied to net derivative assets requires a more in-depth analysis. On the one hand, assets arising from derivative transactions are fundamentally different from "regular" assets, in that they do not need funding; as such, a 0% RSF appears more warranted. On the other hand, as addressed also in the next paragraph, derivative assets are reflected in the regulatory capital via the profit and loss account and therefore a 0% RSF would not be NSFR neutral as in the case of "regular" assets, i.e. it would improve the NSFR. **Thus, a 100% RSF best preserves the NSFR neutrality, which is a prudential measure that recognises that derivative assets should only be allowed to become a stable source of funding in the NSFR to the extent that their realisation is certain.**

The requirement to net derivative assets against derivative liabilities raises some prudential issues, given that it may inadvertently lead to unwarranted improvements in the NSFR ratio. First, we note that the netting requirement has no impact on the computation of the RSF for derivative liabilities, where a 0% ASF factor is applied, irrespective of the size of the derivative assets. Second, the NSFR is improved in cases when derivative assets do not receive any RSF factor because they are lower than derivative liabilities, and when the amount of derivative assets is decreased by the amount of derivative liabilities. This is because the derivative asset is reflected in regulatory capital – via profit and loss – at its gross non-netted value, with a 100% ASF, while the RSF factor is either not applied at all (when the derivative asset is lower than the derivative liability) or applied to an amount lower than the gross derivative asset amount (the case when the derivative assets are higher than the

derivative liabilities and the derivative liabilities partially offset/net the derivative assets). Third, we note that any deduction from the derivative assets – such as cash received as collateral – creates a mismatch between, on the one hand, the available stable funding via the profit and loss account and, on the other hand, the amount to which the 100% RSF factor is applied. This is because the profit and loss account impact would lead to a higher ASF amount than the RSF applied to the derivative assets, given that these assets would be already netted out by the amount of cash received. Finally, we note that, under the current setting, in the case where derivative liabilities are higher than derivative assets the NSFR is negatively affected even if the net derivative liabilities do not attract any stable funding (i.e. they receive a zero ASF factor), given that the available stable funding decreases, via decreases in the profit and loss account. Addressing the issues identified above may require some conceptual changes to the treatment of derivatives in the NSFR.