INSTITUTE OF INTERNATIONAL FINANCE

16 November 2015

Mr Andrea Enria
Chairperson
European Banking Authority
Floor 46
One Canada Square
London
E14 5AA

Dear Andrea,

The Global Financial Markets Association, the Institute of International Finance and the International Swaps and Derivatives Association, (collectively, the "**Associations**") appreciated the opportunity to participate in the European Banking Authority's ("**EBA**") public hearing on 15 October 2015 regarding the potential implementation of the Net Stable Funding Ratio ("**NSFR**") in Europe.[1] We strongly support the underlying policy goals of the NSFR, including its core goal of requiring banks to develop and maintain sustainable funding structures.[2]

We understand that the EBA intends to publish a report by 31 December 2015 containing its recommendations for implementation of the NSFR in Europe and that these recommendations will largely follow the analysis contained in the EBA's draft report delivered at the 15 October public hearing (the "**Draft Report**").[3] We also understand, as stated in the Draft Report, that "the findings and conclusions [in the report] are only preliminary and may change substantially when the analysis is finalised and the full report is published."[4]

The Draft Report includes wide-ranging substantive analysis of many significant policy issues, and we appreciate the EBA's efforts to conduct a thorough, empirical and transparent examination of potential NSFR impacts in Europe before publishing its final report. While the Draft Report represents an important step toward ultimate adoption of the NSFR in Europe, however, we believe that its analysis is incomplete in some significant areas. In particular, we believe that the final report should consider:

- product-level impacts of the BCBS NSFR, especially for European SMEs' securities and well-funded derivatives that do not meet leverage ratio netting criteria;

[1] *See generally* Basel Committee on Banking Supervision, *Basel III: the net stable funding ratio* (Oct. 2014), available at: http://www.bis.org/bcbs/publ/d295.pdf ("**BCBS NSFR**").
[2] *See* BCBS NSFR ¶ 1.
[3] EBA, "Draft report on the calibration of a stable funding requirement under Article 510 CRR" (Oct. 2015), available at: http://www.eba.europa.eu/documents/10180/1181659/PPT+-+report+on+the+calibration+of+a+stable+funding+requirement.pdf
[4] Draft Report, p. 2.

- the ability and willingness of NSFR-surplus banks to support European capital markets if NSFR-deficit banks are forced to withdraw from such markets;

- the interplay of the Capital Markets Union and the BCBS NSFR, including the risk of economic underperformance if European capital markets contract in response to an incorrectly calibrated NSFR standard;

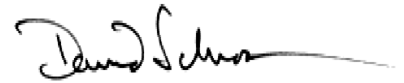
- frictions that may arise between European banks' real-world asset-liability management (ALM) programs and an overly blunt NSFR standard that fails to acknowledge any connection between specific assets and liabilities that facilitate customers' access to capital markets; and

- the extent to which the BCBS NSFR should be revised or adapted to most appropriately support economic growth, job creation and financial stability in Europe.

Accordingly, the Associations are submitting this letter to provide additional information that may assist the EBA in completing its final report by the end of 2015. In addition, this letter responds to several oral comments and questions raised by EBA representatives at the public hearing.

We would welcome an opportunity to discuss the contents of this letter with EBA representatives in the coming weeks as the EBA prepares its final report. In addition, for reference, the Associations' April 2015 submission to the EBA on implementation of the NSFR in Europe is attached (the "Associations' Presentation").

Yours sincerely,



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Association Responses to the Draft Report

1. A broader empirical review of potential NSFR impacts is warranted

The European Commission (the "**Commission**") requested that the EBA prepare an empirical analysis of the potential impacts of NSFR implementation in Europe.[5] In preparing its report, the Commission specifically requested that the EBA consider, among other areas, an analysis of the impact of the NSFR on the volume and liquidity of financial markets at the EU level, including European capital markets; an analysis of the impact of the NSFR on banks' underwriting and market-making activities; and an analysis of the impact of the interaction of the NSFR with risk-based capital requirements and the leverage ratio.[6] The Draft Report does not appear to address these points. We respectfully encourage the EBA to fully address the all topics cited in the Commission Call for Advice as requiring empirical analysis. To the extent helpful, we encourage the EBA to consider preliminary empirical analyses previously submitted to the EBA by the Associations and their member institutions.[7]

We have three comments on the data summarized in the Draft Report. First, as noted above, the Draft Report does not contain any analysis of product-level NSFR impacts, and instead only analyses NSFR averages across European banks generally and across ten large subgroups of European banks. The absence of product-level analysis is particularly striking when one considers broad subcategories like "local universal banks," which the Draft Report indicates includes 80 separate institutions, 21% of which have NSFR deficits.[8] By definition, universal banks engage in a wide range of wholesale and retail activities, although the specific mix of products and services will vary by firm. By excluding any product-level analysis, it is unclear why some local universal banks currently meet the NSFR standard while other do not. We believe it is likely the case that wholesale customer divisions within universal banks (and, in particular, capital markets-focused wholesale divisions) will find it more challenging to meet NSFR standards, whereas retail-focused businesses will generally meet the standards more easily. As a result, local universal banks and similarly situated institutions may be incentivized to shrink their wholesale activities to achieve stronger compliance with the NSFR, weakening broad-based economic growth and job creation in Europe. We recommend that, before publication of the final report, the EBA examine product-level NSFR impacts within European capital markets franchises, consistent with the Commission Call for Advice.

[5] Letter from Jonathan Faull to Andrea Enria, 26 June 2015, available at: http://www.eba.europa.eu/documents/10180/1162591/Call+for+advice.pdf; European Commission, *Call for advice to the EBA for the purposes of the Net Stable Funding Requirements and the Leverage Ratio* (26 June 2015), available at: http://www.eba.europa.eu/documents/10180/1162591/Call+for+advice.pdf ("**Commission Call for Advice**").

[6] Commission Call for Advice, p. 3.

[7] For instance, numerous European banks have provided more granular information to the EBA demonstrating the impact of the NSFR to their derivatives portfolios. In addition, a January 2015 research report by Oliver Wyman describes the BCBS NSFR's possible impacts on capital markets products and services.

[8] Draft Report, p. 13.

Second, the NSFR evolved substantially during its development by the Basel Committee, and therefore the charts plotting European banks' compliance with the NSFR over five measurement periods between 2012 and 2014 may incorrectly suggest that the results are being measured against a single standard, whereas in reality the BCBS NSFR was only finalized in October 2014.[9] Even within 2014, the standards in the January 2014 consultative document differ substantially from those in the October 2014 final report. For example, among other important changes, the October 2014 NSFR introduced a completely new derivatives methodology, substantially changed the Required Stable Funding (RSF) factor for collateralized loans to financial institutions, eliminated the bank/nonbank distinction, and introduced the concept of interdependent transactions. As such, we believe that data based on prior versions of the NSFR cannot be reliably compared with data based on the October 2014 standard, and that the EBA should conduct a more detailed empirical analysis to determine whether European banks' compliance with the final NSFR standard has increased or decreased over a multiple-point observation period. It may be the case that EU banks might not be on an improving path towards meeting the requirements of the NSFR and that the impact of the revised standards might therefore be greater than anticipated.

Third, although not included in the Commission Call for Advice, we request that the EBA examine whether there is sufficient market capacity for European banks to issue the requisite amount of long-term debt or secured funding to close all Available Stable Funding (ASF) shortfalls. In conducting this analysis, we recommend that the EBA take into account the high Required Stable Funding (RSF) factors that will apply to European banks making markets in other European banks' debt securities, which will likely weaken market capacity and liquidity in such instruments. In addition, a holistic review of market capacity should also consider the effect of any Total Loss Absorbing Capacity ("**TLAC**")-related capital deductions or similar penalties that may be imposed on European banks making markets in other European banks' debt securities[10]. We believe that this analysis is critical since issuing more long-term debt is one of the few options within the control of banks to meet NSFR shortfalls without withdrawing credit support from the European economy.

2. Inaccurate NSFR calibrations may impair European economic growth and competitiveness, particularly in the SME sector

The Draft Report suggests that, if NSFR-deficit banks are forced to withdraw credit support from European markets, NSFR-surplus banks will step in to provide replacement credit support in an equivalent amount. For example, the Draft Report includes a chart showing the aggregate ASF excess for all European banks compared against the aggregate ASF shortfall for all European banks, with a line showing that the ASF excess amount and RSF shortfall amount balance out as an ASF excess of approximately €500 billion.[11] The suggestion is that the level of lending and other credit support activity will remain constant in Europe even if NSFR-deficit banks withdraw from the market, since NSFR-surplus banks have sufficient spare capacity to meet market demands.

[9] Draft Report, pp. 9-10. We note that the table on page 9 includes an indication that the final BCBS NSFR standard was published in October 2014.
[10] BCBS Consultation Document, *TLAC Holdings*, November 2015.
[11] Draft Report, p. 10.

We disagree with this analysis, for three reasons. First, because of calibration issues in the BCBS NSFR framework, NSFR deficits are more likely to arise in connection with capital markets activities than with commercial banking activities, and banks without existing capital markets franchises will be unable to meet capital markets demands through incremental expansion. Acting as a market-maker in capital markets requires major fixed-cost infrastructure investments in technology, risk management expertise, and product development; a bank primarily operating in retail lending markets would not be able to become a market-maker without a costly strategic expansion. Further, even if the €500 billion figure were a reasonable proxy for European capital markets-eligible ASF surpluses, the actual surplus capacity would still be much lower, since firms have to manage to buffers above 100 percent compliance and specific ASF-surplus firms may be subject to other binding constraints (leverage, liquidity, etc.) that effectively prevent them from deploying ASF surplus capacity to support capital markets activities. Contrary to the suggestion in the Draft Report that there is a €500 billion funding surplus waiting in reserve to meet any European market withdrawals, the actual impact on European markets is more likely to be a contraction of capital markets activities generally.

Second, we understand that the EBA is evaluating whether, to the extent capital markets-focused banks face NSFR deficits, these banks can simply re-price their products and services to pass incremental funding costs onto end users. While end users may be required to absorb some incremental cost increases, we believe the larger effect will be a contraction of economic activity. For example, one of the most basic capital markets functions performed by banks is making markets in corporates' equity and debt securities. Market-making necessarily requires taking balance sheet positions, resulting in assets that will attract RSF factors. Banks do not have an endless capacity to make markets; instead, they are constrained by their balance sheet capacity and regulatory capital and liquidity standards. A market-making bank cannot "re-price" a corporate equity or debt security that receives an unsustainable RSF factor, as the price of the instrument is determined by broader market forces. Instead, if NSFR requirements are unmanageable, the bank will simply reduce its securities inventory, weakening the corporate issuer's access to investors and impairing market liquidity. We note that this negative effect will be particularly strong for SMEs' securities, since the BCBS NSFR generally applies higher RSF requirements to SME securities than to well-established corporate firms' securities, making it more costly under the BCBS NSFR for banks to make markets in SMEs' securities.[12]

Finally, we believe that any evaluation of NSFR economic impacts in Europe must consider how banks allocate regulatory capital, funding and liquidity costs internally within their organizations, as required by Basel Committee standards.[13] Although exact practices will

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[12] The BCBS NSFR applies lower RSF factors to debt and equity securities that qualify as Level 2B assets for purposes of the Liquidity Coverage Ratio ("**LCR**"), and imposes higher RSF factors on other securities that do not qualify for Level 2B treatment. As a general matter, only large corporates' equity and debt securities are eligible to be considered Level 2B assets.

[13] *See* BCBS, *Principles for Sound Liquidity Risk Management and Supervision* (Sept. 2008), Principle 4, *available at:* http://www.bis.org/publ/bcbs144.pdf ("A bank should incorporate liquidity costs, benefits and risks in the internal pricing, performance measurement and new product approval process for all significant business activities (both on- and off-balance sheet), thereby aligning the risk-taking incentives of individual business lines with the liquidity risk exposures their activities create for the bank as a whole.").

vary by institution, as a general principle banks evaluate internal business units' profitability against all applicable prudential standards; the return on equity of a business unit that produces high regulatory capital requirements, for example, will be evaluated against the regulatory capital required to support that unit's activities. As a result, if capital markets activities in Europe are subject to severe NSFR penalties, every business line within a European capital markets franchise—whether contained within a traditional investment bank or within a more retail-focused institution—will be evaluated against the implied regulatory funding costs of operating such businesses, limiting the ability of an NSFR-surplus bank to "subsidize" the funding costs of a capital markets franchise with retail division ASF surpluses. More broadly, we believe that such business unit-level allocations of regulatory standards are prudent, since they require each unit to manage its capital, funding and liquidity profile responsibly.

3. Implementation of the NSFR in Europe in the manner contemplated by the Draft Report may impair the viability of the Capital Markets Union

The European Commission published its "Action Plan on Building a Capital Markets Union" (the "**Action Plan**") on 30 September 2015.[14] As noted in the Action Plan, "Europe's capital markets are still relatively underdeveloped and fragmented. The European economy is as big as the American one, but Europe's equity markets are less than half the size, its debt markets less than a third."[15] The Action Plan acknowledges "widespread concerns that the EU regulatory environment may not be conducive to further development" of public equity and debt markets, and identifies several significant reform efforts that can help improve the vibrancy and functioning of these markets.[16] The Action Plan also notes that capital markets can play an important role in financing for SMEs, and several provisions aim to achieve greater SME capital markets access.[17] Notably, however, the Draft Report includes no references to the Action Plan or the Capital Market Union, despite the Action Plan's assertion that the European Commission's "top priority is to strengthen Europe's economy and stimulate investment to create jobs."[18]

In its current form, the BCBS NSFR represents a major challenge to a well-functioning Capital Markets Union because of the high RSF factors applied to all equity and debt securities, even when such securities are supported by appropriate customer-facing liabilities. For example, a bank holding a European SME corporate's equities securities on its balance sheet would generally be required to apply an 85 percent RSF factor to the securities, even in situations where the bank's customer has provided 100 percent of the funding to the bank and the bank only holds the securities as a market risk hedge on a customer-facing derivative. These commonly used customer-funded arrangements expand the base of investors who can access European capital markets from abroad when they lack the operational capabilities to invest directly in European securities.

[14] European Commission, *Action Plan on Building a Capital Markets Union* (30 Sept. 2015), available at: http://ec.europa.eu/finance/capital-markets-union/docs/building-cmu-action-plan_en.pdf
[15] Action Plan, p. 3.
[16] Action Plan, p. 12.
[17] Action Plan, pp. 9-10, 12-13.
[18] Action Plan, p. 3.

In other cases, European investors seeking to invest in European companies' equity and debt securities may access capital markets through investment accounts at banks. In some cases these investment arrangements result in the bank being required to recognize certain assets (e.g., cash) related to customer payables as segregated assets held on the bank's balance sheet, even though they are held for the benefit of customers and customers fund the positions. Because the BCBS NSFR applies RSF requirements to all balance sheet assets, mechanical application of the BCBS NSFR in Europe would result in banks' capital market intermediary services—including, but not limited to, customer asset segregation arrangements—receiving unsustainably high RSF requirements, unnecessarily impairing banks' ability to perform one of their most basic market functions.

Another important capital markets intermediary service performed by banks is assisting European SMEs hedge their risks through derivatives. As noted, the BCBS NSFR introduced a completely new derivatives methodology that differed substantially from any prior consultative document, including a 100% RSF factor applied to 20% of a bank's derivatives liabilities and application of leverage ratio netting criteria to a bank's derivatives assets, which has the effect of derecognizing non-cash collateral received by banks from counterparties and requires that cash variation margin received should fully offset any exposure before it may be recognised. These requirements apply generically to a bank's entire derivatives portfolio, even though in many cases SMEs do not cash collateralize their derivatives and the Basel Committee itself has generally exempted SMEs from regulatory margin standards for derivatives.[19] As a result, the BCBS NSFR may weaken European SMEs' access to risk-hedging tools in financial markets (or raise the cost of such access), even though the BCBS margin framework expressly attempted to preserve affordable derivatives market access for SMEs.

Finally, as another example, banks regularly engage in securities-for-securities "upgrade" transactions in which the bank lends non-HQLA securities, such as an SME security, and receives HQLA securities in return, such as high-quality sovereign debt. These transactions facilitate banks' ability to make markets in non-HQLA securities, including SMEs' securities, by opening additional funding avenues. The BCBS NSFR, however, would have odd impacts on upgrade transactions. An unencumbered SME security receiving an 85% RSF factor at the outset of the transaction would become subject to a 100% RSF factor (as an encumbered security) after being placed in the upgrade transaction, even though a higher-quality security is received in return. As a result, in its current form, the BCBS NSFR would weaken a reliable funding source used to support market-making in SME securities.

We respectfully request that the EBA consider addressing the interplay of the NSFR with the Capital Markets Union in its final report. In conducting this analysis, we recommend that the EBA consider the extent to which equity and debt securities held on banks' balance sheets represent long-term investments by such firms that require stable funding, on the one hand, as compared to situations in which balance sheet assets are either

[19] BCBS and Board of the International Organization of Securities Commissions, *Margin requirements for non-centrally cleared derivatives*, ¶2(c) (March 2015) ("The BCBS and IOSCO believe that the margin requirements need not apply to non-centrally cleared derivatives to which non-financial entities that are not systemically important are a party . . . .").

directly funded by bank customers (e.g., segregated customer assets, customer initial margin-funded derivatives hedges) or otherwise support risk management in short-dated market access transactions for customers (e.g., other derivatives hedges), on the other hand. Applying higher RSF factors to the latter category, we believe, will substantially impede the emergence of a vibrant Capital Markets Union, frustrating the European Commission's policy goals.

4. The Draft Report does not address the fundamental conceptual weakness in the BCBS NSFR, which is the absence of ALM principles, resulting in mistaken assumptions about bank funding models

As noted in our letter, we strongly support the underlying policy goals of the NSFR, in particular its core goal of requiring banks to develop and maintain sustainable funding structures. Since the financial crisis, many European banks have prioritized these policy objectives into their liquidity and funding risk management frameworks, reducing utilization of commercial paper and wholesale deposits and shifting to asset-liability management (ALM) programs relying on greater capital, long-term debt, term-dated secured funding and sticky deposits.

The BCBS NSFR, however, is not an ALM framework. Instead, the NSFR evaluates assets and liabilities in isolation, assigning required stable funding (RSF) and available stable funding (ASF) factors without regard to how those assets and liabilities support an overarching ALM program. In reality, of course, banks manage their assets and liabilities through ALM principles. For instance, while the NSFR applies 50 percent and 85 percent RSF factors to many securities, a bank's actual funding requirements for such securities would depend on whether they are held as a hedge to a customer-facing position (and, if so, whether funded by the customer), as market-making inventory, or as part of the bank's own investment portfolio.

The Draft Report does not discuss ALM principles. We respectfully recommend that the EBA conduct further analysis on whether the NSFR reinforces prudent ALM programs at European banks, taking into account the range of liabilities that are necessary to support capital markets franchises. In particular, in conducting this analysis, we recommend that the EBA evaluate whether it would be impractical to extend the maturities of certain customer-facing liabilities—such as segregated customer asset payables and customer short sale proceeds—that are core elements of healthy and vibrant European capital markets. To the extent the EBA recognizes that these customer-facing liabilities are necessarily short-dated, we recommend that the EBA consider appropriate accommodations in the European NSFR grounded in ALM principles.

The Associations, working with their members, previously identified a number of transactions in which the prudent application ALM principles may result in short-dated liabilities for specific transaction categories. *See generally* Appendix A. We believe that these transaction examples provide the EBA with a useful frame of reference for examining, in capital markets franchises, the interplay of BCBS NSFR standards with ALM principles and the potential need for reasonable ALM-focused accommodations in Europe's implementation of the NSFR.

5. **The Draft Report does not consider that the NSFR is only a high-level framework and that BCBS itself acknowledges that some amount of tailoring is appropriate in national implementation**

The BCBS NSFR contains 13 pages of text, only a handful of which prescribe RSF and ASF factors for specific categories of assets and liabilities, respectively. As such, it is necessarily a high-level framework based on very general assumptions about bank funding models. As the Draft Report itself acknowledges, however, there is a wide range of bank business models in Europe, from small-scale mortgage and building societies providing home loans in local markets to European universal banks with global operations across numerous categories of wholesale and retail activities. By necessity, European authorities will need to make choices when implementing the NSFR, including by interpreting and applying very general NSFR ASF and RSF categories to an extremely diverse product marketplace.

The BCBS NSFR itself acknowledges this fact by providing national supervisors with "discretion in limited circumstances" to assign 0 percent RSF and ASF factors to "interdependent" assets and liabilities.[20] The Associations have previously discussed with EBA representatives a small set of transaction examples in which, we believe, the resulting assets and liabilities meet the interdependent criteria contemplated by the BCBS NSFR. These transaction examples are consistent with the goal of ensuring the banks have appropriately stable sources of funding, taking into account ALM principles and the Commission's policy goal of developing a robust Capital Markets Union.

More broadly, we encourage the EBA to conduct a more holistic review of the economic consequences of applying the BCBS NSFR to Europe and the extent to which some amount of tailoring—whether through recognition of specified interdependent transactions or otherwise—would be appropriate in light of the particular characteristics of Europe's economy and the European Commission's policy priorities. We believe that the BCBS NSFR provides a starting point for the establishment of new regulatory standards in Europe, but that European authorities should recognise that important questions of national-level implementation remain open for consideration.

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In closing, we highlight the request in the Commission Call for Advice seeking "an analysis of the impact of the interaction of the NSFR with risk-based capital requirements and the leverage ratio."[21] We suggest that the EBA broaden this analysis beyond leverage and risk-based capital requirements to also consider the interplay of the NSFR with other prudential standards, including the Liquidity Coverage Ratio (LCR), TLAC, Global Systemically Important Bank (GSIB) capital buffers, and other recently enacted or proposed prudential standards. Through its application to the entirety of banks' assets and liabilities, the NSFR may result in dramatic changes to balance sheet management practices that are in tension, or even conflict, with other balance sheet-focused prudential standards. Moreover, in many areas other standards have already at least partially addressed some of the NSFR's underlying policy goals, a fact that should

[20] BCBS NSFR ¶ 45.
[21] Call for Advice, p. 3.

be recognized in NSFR implementation standards to avoid creating unnecessary frictions. For example, the 100 percent RSF factor applied to 20 percent of a bank's derivative liabilities may be redundant in light of the LCR's derivatives-related outflows.

Finally, we also note that the BCBS NSFR itself remains a new, untested standard which is subject to ongoing review by BCBS. For instance, the Basel Committee stated in the BCBS NSFR that it "will continue to evaluate the treatment of margining in the NSFR," including by conducting "quantitative analysis and [will] consider alternative approaches, if necessary and appropriate."[22] As the Basel Committee itself considers modifications and recalibrations to the global standard, we encourage the EBA to consider whether European authorities should support efforts to appropriately amend the BCBS NSFR to better reflect prudent bank funding practices or observed regulatory impacts on the European economy. Additionally, to the extent the EBA makes changes it should work to achieve parallel amendments at BCBS level to improve the international standard and facilitate consistency.

[22] BCBS NSFR ¶ 42(a).