German Banking Industry Committee

Die Deutsche Kreditwirtschaft

Position on the implementation of the NSFR in the EU

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The **German Banking Industry Committee** is the joint committee operated by the central associations of the German banking industry. These associations are the Bundesverband der Deutschen Volksbanken und Raiffeisenbanken (BVR), for the cooperative banks, the Bundesverband deutscher Banken (BdB), for the private commercial banks, the Bundesverband Öffentlicher Banken Deutschlands (VÖB), for the public banks, the Deutscher Sparkassen- und Giroverband (DSGV), for the savings banks finance group, and the Verband deutscher Pfandbriefbanken (vdp), for the Pfandbrief banks. Collectively, they represent approximately 1,700 banks.

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GBIC position on the implementation of the NSFR in the EU

By end of 2016 the EU commission has to deliver a proposal in which form to implement the Net Stable Funding Ratio (NSFR) in the EU. The German Banking Industry Committee (GBIC) is pleased to present its priorities relating to this endeavour covering nine different topics. As pointed out in the following paragraphs the NSFR, as currently drafted by the Basel Committee shows significant shortfalls in terms of calibration, complexity and proportionality which could be dealt with by the EU commission.

Appropriate treatment of derivative contracts

The Basel Committee on Banking Supervision proposes an asymmetrical treatment of net derivative liabilities and net derivative assets. Whereas net derivative liabilities cannot be accounted for as stable funding (ASF: 0%), net derivatives assets have to be fully backed by stable funding (RSF: 100%). In this context, when calculating the NSFR derivative assets, according to para. 35 of the Basel NSFR standard only collateral that is received in the form of cash variation margin can offset the positive replacement costs. This approach, from our point of view, is far too restrictive. LCR level 1 liquid assets are often used as collateral in derivative contracts. Particularly in view of new statutory requirements (e.g. EMIR) that call for the provision of initial and variation margin for derivative contracts outside CCPs, the market will move away from cash collateral towards securities collateral in derivative contracts. For example, various counterparties - such as insurance firms and investment funds - do not hold sufficient cash assets and will therefore want to post securities as collateral. We anticipate a similar trend towards securities collateral for financial institutions. We, therefore, propose recognising variation margin posted in the form LCR level 1 liquid assets and using the LCR haircuts for this collateral.

Additionally, the Basel Committee wants to apply a 100% RSF factor to 20% of the gross derivative liabilities. In this context, banks have to account for the negative replacement costs before deducting variation margin posted. We understand that this treatment of derivatives liabilities is intended to cover the additional collateral that the bank should post in case of an adverse market movement. In this case, the assumption is that the bank's derivatives with a negative market value would turn even more negative, triggering additional collateral requirements which need to be funded long-term, i.e. requiring RSF.

In our view, this gross approach has one main shortcoming:

- It is asymmetrical, as it does not consider the impact of the same (adverse) market movement on the market value of derivative assets, i.e. assets with a positive market value. In a derivatives book which is globally risk-balanced (as in the case of large market-making books), the positive market value of derivative assets would increase by the same proportion, triggering an increase in cash collateral received. To sum up, the market movement would have no impact on liquidity and the collateral received could be expected to stay on the books as long as the collateral posted.
- Example: Let us consider a simplistic derivatives book consisting of 2 OTC swaps with 2 different counterparties (payer and receiver at 4%, amount: €100 m, residual maturity: 5 years, current market at 2%) with collateral agreements in place (as will be required for regulatory purposes under EMIR). In T_0 the balance sheet looks as follows:

Assets	
Derivative assets	9.4
Cash collateral posted	9.4

Liabilities	
Derivative liabilities	9.4
Cash collateral received	9.4

GBIC position on the implementation of the NSFR in the EU

- After 1 year, an increase in the derivatives liabilities by 20% means that the derivative liabilities stand at 11.3 and the market rate now stands at 1.1%. The balance sheet now looks like:

Assets	
Derivative assets	11.3
Cash collateral posted	11.3

Liabilities	
Derivative liabilities	11.3
Cash collateral received	11.3

- As demonstrated, the cash collateral posted has moved in the same magnitude as the collateral received. A funding risk arises if the cash collateral posted increases more than the cash collateral received.

We, therefore, consider "derivatives liabilities" to be an unsuitable metric for quantifying the risk of an outflow of liquidity (cash) in the context of collateralisation of derivatives. This approach leads to unduly high volatility in the NSFR ratio that cannot be desired from a supervisory standpoint either. Any RSF factor applied to derivatives liabilities means a double penalty for this business with unintended consequences for the real economy: the actual NSFR rules on derivatives are already very conservative and do not have to include any additional stable funding requirement.

On the other hand, SA-CCR is a measure of potential market value changes for individual counterparties and thus is only based upon a single netting set between the bank and that counterparty. Thus, an SA-CCR approach will not take into account the important netting diversification effect of funding requirement across all counterparties. In this context, the current SA-CCR is viewed to significantly overestimate the risk of changes in funding requirements and it will not act as a good measure of the risk of changes in the funding requirements.

Therefore, we suggest the Commission considers the use of a Delegated Act to develop the most appropriate treatment of derivatives in the NSFR to allow more time to assess the most appropriate solution.

Less risk-sensitive but operationally less burdensome metrics for smaller banks in terms of potential exposures due to derivatives

Due to the complexity of the new SA-CCR for measuring market risk, small and medium-sized credit institutions with a small derivatives portfolio (e.g. unsecured interest rate swaps as hedging instruments for interest rate risk in the banking book), should have the right to keep using the current framework. This means using a less risk-sensitive but operationally less burdensome metric. We are of the opinion that for this group of institutions the use of the current Original Exposure Method (OEM) would be sufficient.

Nevertheless, these institutions should have the option of deciding which method to use.

Symmetric treatment of secured lending among banks

The short-term liabilities resulting from collateralised borrowing (repos) cannot be recognised as available stable funding (ASF). On the other hand, however, banks have to assign collateralised loan exposures (reverse repos) a RSF factor of 10% or 15%, depending on the collateral's liquidity. Collateralized short-term interbank liquidity plays a key role in the efficient and smoothly functioning of financial markets and is, thus, a major factor in ensuring financial stability. The non-recognition of short-term repo transactions as available stable funding (ASF) would adversely affect the willingness of banks to provide collateralized liquidity. This may lead to a significant decline in market activity in this segment and seriously hamper short-term liquidity management through collateralised transactions between financial institutions. This,

in turn, could result in a lack of market liquidity in this segment. We, therefore, propose a NSFR-neutral treatment of collateralised short-term transactions, i.e. identical ASF and RSF factors. Accordingly, collateralised loan exposures (reverse repos) should be assigned an RSF factor of 0% where transacting with regulated financial entities.

Improving the treatment of short-term trade and export finance

From our point of view, trade and export finance would be penalised under the NSFR. The new stable funding requirement could, as the EBA has outlined in its report on the NSFR, increase the costs of the trade finance provided by banks, including lending under official export credit insurance schemes and more acutely short-term, uncommitted, trade-related self-liquidating exposures. This could, in turn, lead to banks abandoning this business altogether. Unfortunately, the EBA concludes that such negative effect could be offset by Export Credit Agencies (ECAs) providing credit directly to exporters and importers (instead of providing cover as most of them do today), in other words by crowding out the private sector and increasing the public involvement and funding. From our perspective, this is not a viable solution and ignores the European system.

In Europe, there has been a long-standing division of labour between ECAs and commercial banks. The banks normally supply financing for the sale and associated local costs, alongside advice and local knowledge. They are also fully responsible for credit administration and monitoring, implying less work and cost for the ECA. The ECA would come into play only in case of default. Therefore, commercial banks play a crucial role in facilitating the financing of viable export transactions in a market-driven economy. The objective of banking regulation should be to enable banks to fulfil their role as intermediary in a responsible way and not to set incentives for more state intervention and public dependency.

Regarding the calibration of the NSFR, we ask for confirmation that a RSF of 65% applies to export credits with a residual maturity of more than one year covered by ECAs of the EU Member States. We also recommend that trade finance loans should receive a 0% RSF (instead of 15%) when their residual maturity is lower than 6 month, 25% (instead of 50%) below 1 year, and 85% otherwise and that no off-balance sheet commitment should be allocated a higher than 5 % RSF.

Finally, we would like to point out the debate on performance guarantees and letters of credit. We disagree with the EBA report’s recommendation that these items should be subject to an RFS. In the case of performance guarantees, its execution is subject to a performance event under a commercial contract. ICC studies show that the execution level of these guarantees is very low (8%). In fact, the LCR already takes into consideration this feature by allowing national supervisor to decide whether a liquidity buffer for that guarantee is needed. The approach is similar to the letters of credit.

Covered Bonds

Mapping covered bonds and the corresponding cover assets gives rise to several aspects which put Pfandbrief banks at a disadvantage:

1. The statutory requirement, plus credit rating agency requirements, lead to significant over-collateralisation requirements for covered bonds. For AAA-rated bonds, these are usually well above the nominal value. Due to the fact that cover assets are usually assigned a 100% RSF (required stable funding) factor, every long-term covered bonds issue puts a considerable strain on the NSFR, as the covered bonds only generates corresponding ASF amounts up the level of its nominal value and the over-collateralisation requirements thus have to be additionally funded long-term.

GBIC position on the implementation of the NSFR in the EU

A solution would be a requirement to take into account over-collateralisation exceeding the statutory requirements merely by way of the RSF factors that apply where these assets are not used as cover.

2. Long-term loans are subject to an RSF factor of 85% (65% in case of mortgage loans equivalent to a risk-weighting of 35%) if they are unencumbered and to a 100% factor if they are encumbered. Non-covered bonds banks are not, however, required to prove that they are operationally able to liquidate the loans (or 15% thereof). Covered bonds banks will have these loans in their cover pool, i.e. fully encumbered.

On the ASF (available stable funding) side, maturing covered bonds are, however, treated as maturing unsecured. Short-term/maturing covered bonds do not therefore enjoy compensatory privileged status within the ASF although the ability to liquidate loans was demonstrated (via the issue of covered bonds).

The easiest and most appropriate solution is not to distinguish whether mortgage loans are refinanced via covered bonds or through other sources like senior unsecured funding. The following scenario illustrates this point:

- The outstanding volume of the covered bond is 100
- The value of the encumbered assets is 100
- For the sake of simplicity, we do not include any over-collateralisation
- The due date of the bond is 1 year at the date T0
- The dates T1, T2 and T3 are 6, 9 and 12 months after T0 and T4 is the refinancing date
- At T3 the bond is due and refinanced by a senior bond

The NSFR, other thing equal, would then show this pattern:

	T0	T1	T2	T3	T4
		6 months	9 months	12 months	
ASF	100	50	0	0	100
RSF	100	65	65	65	65
NSFR	100 %	77 %	0 %	0 %	154 %

If, instead, the amount due is refinanced by a covered bond at T4, the NSFR would develop as such:

	T0	T1	T2	T3	T4
		6 months	9 months	12 months	
ASF	100	50	0	0	100
RSF	100	65	65	65	100
NSFR	100 %	77 %	0 %	0 %	100 %

The example shows, if the amount due were to be refinanced by a senior unsecured bond with a maturity of more than one year, the NSFR would look much better compared to the refinancing by a long term covered bond. This does not reflect the real refinancing risk in an appropriate manner and would raise – probably as unintended consequence – the refinancing and liquidity risks. Therefore, assets in covered bond cover pools should be treated as unencumbered just as if the assets were funded by deposits or other instruments.

In order to mitigate the unintended consequences at least, covered bonds should be allocated an ASF of 100% even for maturities below 1 year.

GBIC position on the implementation of the NSFR in the EU

Considering of "repricing date (spread fixing date)" for mortgage loans instead of contractual maturity

For mortgage loans the repricing date instead of the contractual maturity should be considered. At this date the customer has to negotiate with the bank for new conditions of the loan (interest, new repricing date, etc.). So various possibilities are given at this date:

a. The customer prolongs the whole repricing volume to a new repricing date
b. The customer prolongs only a part of the repricing volume (repaying the other part) according to a new repricing date
c. The customer pays back the whole repricing volume

Due to the above mentioned possibilities the bank is refinancing the loan according to the repricing date and not according to contractual maturity to avoid refinancing risk.
Taken the current NSFR approach into consideration it would mean that the loan is reported 30 years while refinanced 10 years according to repricing date. Thus in 9 years the ASF weighting decreased from 100% to 50% (running down from ≥ 1 year to the shorter buckets) while the weighting for the loan remains at 100% (encumbered loan). This would lead to an asymmetric consideration of the loan and its respective refinancing.

Proportionality

The implementation of the NSFR, as proposed by the Basel Committee on Banking Supervision, would have significant unintended consequences for smaller banks. In our view, the costs of implementing the NSFR for small and medium-sized banks would be out of all proportion to the intended purpose of safeguarding minimum structural liquidity. We, therefore, support further work on possible alternative metrics which produce comparable results but are operationally less burdensome in order to achieve an effective application of the principle of proportionality.

It would, for example, make sense in our opinion to reduce model complexity and granularity of the information reported in particular. To this end we are of the opinion that certain institutions should be allowed to stick to alternative metrics like a minimum core funding ratio (CFR).

The CFR for example is a quantitative one-year structural funding metric and compares "the core funding" over total assets. The nominator and thus the metric as a whole consists only of a few items compared to the 1.500 data points of NSFR, as currently drafted. Hence, this metric would significantly reduce complexity and, first and foremost, operating expenses.

The Commission should consider the use of a Delegated Act to define an alternative measure for certain banks to allow more time to assess the most appropriate solution.

In order to identify the institutions that could make use of alternative metrics competent authorities should take into account that various studies have pointed out that LCR and NSFR would be equivalent in case of common parameter definitions. The LCR is a complex metric requiring considerable implementation effort. It should be seen in combination with the ALMM concentration metrics as a sufficient quantitative measure for assessing the liquidity risk profile. However, since there is the need to calculate a structural liquidity metric, this burden should be as light as possible for institutions passing a certain LCR ALMM test. This test has yet to be calibrated, also taking into account the general liquidity framework of institutions such as membership of a deposit guarantee scheme or an institutional protection scheme and limited capital-market orientation.

GBIC position on the implementation of the NSFR in the EU

Appropriate treatment of pass-through structures

In line with their focus on regional business activities, small and medium-sized credit institutions often pass through promotional loans granted by promotional banks such as Kreditanstalt für Wiederaufbau, which is owned by the German federal government. Promotional loans significantly improve retail and SME clients' access to loans. The well-established pass-through structure ensures well-informed credit decisions on behalf of the promotional bank. The NSFR, as currently drafted, impedes the passing through of promotional loans under certain circumstances. This may have negative effects on the business activities of small and medium-sized credit institutions.

Promotional loans always have to be applied for through the borrower's bank. Generally speaking, passing through promotional loans is not a problem under the NSFR. If the term of the loan is shorter than twelve months, the borrower's bank would have to assign a 50% ASF factor to both its claim against the borrower and the borrower's liability to it. The ASF factor is 50% because the promotional bank is a public entity. In practice, promotional loans in the public and cooperative banking sectors are, however, often passed through via a central institution (Landesbank or DZ-Bank). In this case, the borrower's bank has a claim against the borrower on the one hand and a liability to a bank on the other hand. This liability to a bank could no longer be counted as stable funding (0% ASF factor) by the bank passing through the loan if it has a term of less than six months.

These pass-through structures meet all requirements of "interdependent assets and liabilities" in para. 45 of the Basel Committee's NSFR standard of October 2014: The liability to the central institution cannot fall due while the promotional loan remains on the balance sheet. Principal payments from the promotional loan cannot be used for anything other than repaying the liability to the central institution. The funding provided by the central institution cannot be used to fund any other assets. The promotional loan and the liabilities to the central institution are clearly definable; their principal amount is the same. The bank is acting solely as a pass-thorough unit to channel the funding received into the corresponding promotional loan. The counterparties of the liabilities and assets are not the same. Therefore, passing through promotional loans, by the standards of the Basel Committee on Banking Supervision, does not change the structural liquidity risk of the savings or cooperative banks.

We, therefore, propose applying a symmetric 0% RSF and ASF factor to assets and liabilities that arise from passing through promotional loans. A similar provision has been introduced in the EU's implementation of the LCR. Such a provision would reduce the burden on small and medium-sized credit institutions and strengthen SME lending.

Scope of application

In our view, the NSFR liquidity risk should have to be calculated and covered solely at the global consolidated group level. We are also concerned that the introduction, in 2018, of NSFRs applying to individual legal entities within banking groups managed on a group consolidated basis could have potential unintended consequences, which require further careful analysis. We urge the Commission to extend the monitoring period for the NSFR at the legal entity level, to allow time for further analysis and for the impacts of the introduction of the LCR and MREL regimes to be fully understand.

In principle, the NSFR should only apply at the global consolidated level because its objective "is to reduce funding risk over a longer time horizon by requiring banks to fund their activities with sufficiently stable sources of funding in order to mitigate the risk of future funding stress". The consolidated NSFR already mitigates the risk of stress arising because of broader market or group-wide firm-specific issues. And it is not clear that an individual NSFR would significantly increase the mitigation of the risk of a legal

entity specific stress. Where entities are reliant on funding from outside of the group and such funding came under stress, the (unstressed) wider group to which the entity belongs would already have very strong incentives and the ability to replace the external term funding that is no longer available with internal term funding as necessary. Where entities are not reliant on external funding, there is no entity-specific funding risk to be mitigated: the intragroup providers of funding have no incentive to create a funding crisis for an entity within their group by, for example, refusing to roll over short term deposits. Internal funding can be considered stable, whatever its contractual term.

Individual entity NSFRs have the potential to impede the free flow of funds within groups, making them less able to respond to stress using their own resources. For example, firms could respond by contractually terming out their intragroup funding, with the result that funds cannot be redeployed to where they are needed at short notice. There is potential for such terming out to interact with LCR requirements, resulting in an increase in the liquid assets required by the providing entity of such funding. This could therefore drive up de facto liquidity requirements across the group, resulting in a tighter calibration of both NSFR and LCR the group level than had been intended.

Moreover, there is scope for individual entity NSFRs to interact with possible MREL requirements. Downstreaming of debt from a parent to a subsidiary to meet the MREL required at the individual parent entity level. This would increase the NSFR applicable to the parent on an individual basis, requiring the parent to raise more term debt than would be required just to comply with MREL on an individual basis. This could result in tighter calibration of MREL than had been intended.

If the NSFR is applied at the individual entity level without further monitoring or analysis, we would urge the Commission to make provision for waivers to be obtained by firms with centralised liquidity management without undue difficulty. The timelines for the introduction of the NSFR by 1 January 2018 requirements are very challenging and it would be important to allow firms and authorities adequate time to prepare and assess applications for waivers before any individual entity requirements came into force. We would therefore urge a start date for any individual entity NSFR regime of no earlier than 1 January 2022. Moreover, if an entity is very dominant within a group, it should be allowed to waive the application of the NSFR for this entity as no further insight is generated if it holds the bulk amount of the group's assets. In order to reduce administrative burdens on firms and authorities, it should also be made explicit that the granting of a waiver from the LCR on an individual basis under CRR Article 8 should automatically result a waiver being granted from the NSFR, without need for further waiver applications.