ESBG response to the Commission consultation on further considerations for the implementation of the NSFR in the EU

ESBG (European Savings and Retail Banking Group)
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Dear Sir/Madam,

Thank you for the opportunity to comment on the Commission consultation on further considerations for the implementation of the NSFR in the EU. We would like to share with you the following remarks:

**Question 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?**

One unintended consequence of an enforced NSFR, which is of utmost importance in particular for smaller banks, refers to the costs of implementing reporting requirements. In our view, the additional burden of costs is not proportionate in terms of the intended purpose of measuring the structural liquidity profile of small and medium sized regional banks. Hence, we voice our support for conducting further work on possible metrics for an effective application of the principle of proportionality. In this instance, ESBG would be in favour of having a minimum Core Funding Ratio (CFR) or the Deposit-to-Asset Ratio (DtAR) in place. Such metrics are, compared to the NSFR, more transparent, better calibrated and a reporting requirement that is easier to implement.

The subsequent paragraphs particularly illustrate the situation of covered bond companies and banking groups issuing covered bonds to fund their mortgage portfolios. At the same time, however, ESBG would like to underline that other entities would face very similar problems in respect of the NSFR.

*(The following paragraph (“In the Basel definition….at solo level”) shall be our answer not only to question 1 but also to question 9):* In the Basel definition of the NSFR, mortgage loans funded by covered bonds are regarded as encumbered and hence receive a higher required stable funding (RSF) weight, compared to mortgage loans funded by e.g. shorter term senior bonds. This provides negative incentives for Mortgage Credit Institutions funded by covered bonds by replacing covered bonds by shorter term senior bonds. In one particular country where an ESBG member is headquartered, covered bond companies are required to be set up as separate legal entities and they are not allowed to take deposits from clients. In addition, those institutions usually do not have other funding sources than covered bonds and may hence have difficulties to meet the NSFR requirement at solo level. Therefore, ESBG suggests exempting such institutions from the NSFR requirement at solo level. The same exemption should also apply at group level for retail banks with a significant mortgage lending business, and which are funding their mortgage portfolio mainly with covered bonds.

We recognise the fact that the RSF is calibrated in order to reflect the different degrees of liquidity, i.e. the required stable funding, of the different asset classes. As such, mortgages are seen as more liquid than other long term loans, which is reflected by the 65% RSF. However, if encumbered the RSF is changed to 100%. Covered bond companies have a business model that is heavily penalised by this NSFR requirement. Furthermore, for retail banking groups with a high proportion of mortgage assets on the balance sheet, and which are funding them with covered bonds, the punitive treatment is transferred to the group, making it difficult to comply with NSFR at group level too. Using mortgage loans as collateral for covered bonds does not have the same effects as other types of collateralisation. First of all, if the covered bond company or the bank at a maturity date were unable to refinance the amount due with a new covered bond, all the assets that have been pledged would suddenly be unencumbered, and they receive a new and lower RSF. Including any over-collateralisation (which is required either by market participants/rating agencies or regulation) this effect could be significant. If, for example, the amount being due is refinanced by an ordinary senior bond with a maturity of more than one year, the NSFR would be much better than if it is refinanced with a long term covered bond. This does not seem to
reflect the real refinancing risk in an appropriate manner. Neither would it be an intended development as it would raise the refinancing and liquidity risks in such business models.

We would like to illustrate this issue with the following case:

- For the case of simplicity, we do not include any over-collateralisation in this example;
- The outstanding amount is 100;
- The value of the encumbered assets is 100;
- 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 would then show this pattern:

<table>
<thead>
<tr>
<th></th>
<th>T0</th>
<th>T1</th>
<th>T2</th>
<th>T3</th>
<th>T4</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>6 months</td>
<td>9 months</td>
<td>12 months</td>
<td></td>
<td></td>
</tr>
<tr>
<td>ASF</td>
<td>100</td>
<td>50</td>
<td>0</td>
<td>0</td>
<td>100</td>
</tr>
<tr>
<td>RSF</td>
<td>100</td>
<td>65</td>
<td>65</td>
<td>65</td>
<td>65</td>
</tr>
<tr>
<td>NSFR</td>
<td>100 %</td>
<td>77 %</td>
<td>0 %</td>
<td>0 %</td>
<td>154 %</td>
</tr>
</tbody>
</table>

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

<table>
<thead>
<tr>
<th></th>
<th>T0</th>
<th>T1</th>
<th>T2</th>
<th>T3</th>
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<td></td>
<td>6 months</td>
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<td>ASF</td>
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<td>RSF</td>
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<td>77 %</td>
<td>0 %</td>
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Another related issue for covered bond companies and for banking groups issuing covered bonds to fund their mortgage portfolios, which is also illustrated by the example above, is the lack of harmonisation between the ASF of the covered bond and the RSF of the encumbered assets as soon as the residual maturity for the covered bond is shorter than 1 year. The ASF for the covered bond would be just 50% for the period 12 to 6 months before maturity and 0% for the rest of the period until maturity. The RSF of the encumbered mortgages would be 65% during the whole period from 12 months before maturity and until the maturity date (subject to the condition that the mortgages are long term mortgages). This would really require such companies to prefund any amounts 6 to 12 months ahead in order to keep the NSFR stable and above 100%. Of course, one could argue that a business model using ordinary senior bonds would also need to prefund in advance. But by using senior bonds the company do not need to use collateral. The covered bond company would need to “double up” the collateral pool to be able to prefund the necessary amount. However, that would not be enough due to the lack of harmonisation between ASF and RSF for such positions. In reality, the covered bond company would need to always be funded by own funds capital or ordinary senior bonds covering up the necessary differences in order to keep the NSFR above 100%. As illustrated above, during the last 12 months before the covered bond’s maturity date this would require significant amounts of such additional funding. The proceeds from such additional funding would be required to be invested outside the collateral pool in order to be unencumbered.
The mechanisms illustrated and described above would be a potentially huge cost driver and probably contribute to an increase in the customers’ borrowing costs. Together with the normally lower refunding and liquidity risks in covered bond companies compared to banks relying on other types of funding for financing their mortgage portfolio, it would, in ESBG’s opinion, be reasonable to keep covered bond companies outside the scope of the NSFR requirement. This exemption should apply both at solo level (the covered bond company or the mortgage institution) and at the level of the group (the banking group funding their mortgage lending with covered bonds).

In this context, regarding covered bonds with a residual maturity of less than 12 months, one needs to stress that the current NSFR proposal would lead to a significant cliff effect between a faster phase-out of covered bonds compared to the respective (encumbered) asset pool belonging to those covered bonds. Assuming theoretical 1:1 funding and disregarding the given negative effect of required over-collateralisation, this cliff effect could prove to be a disincentive for issuers to use covered bonds to fund mortgage loans. Reluctance to issue covered bonds could significantly hamper the overall market activity in covered bonds and a potential removal of supply in covered bonds. In return, it would weaken or even dry out the existing bond market and its usage as a safe refinancing measure for institutions.

Another aspect that ESBG would like to highlight as potentially having unintended consequences is the asymmetric treatment of short-term lending and borrowing to financial institutions, if it would be applied for intra-group transactions without differentiation. Without differentiating it would surely unduly deteriorate the NSFR ratio of involved entities on solo-level. Therefore, we would like to suggest a symmetrical treatment of short-term lending and borrowing to financial institutions belonging to the same group (please also see our comment on question 7).

**Question 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-CCR 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).

For many small and medium-sized credit institutions with a relatively small derivative portfolio (e.g. unsecured interest rate swaps as hedging instruments for the interest rate risk in the banking book) the use of the standardised approach for measuring counterparty credit risk exposures (SA-CCR) would be difficult to deal with. For those institutions using the current Original Exposure Method (OEM) would be sufficient, in ESBG’s opinion.

Furthermore, in our view, the use of the 20% RSF factor related to gross derivative liabilities is not a good measure of the potential change in the funding requirements generated by the derivate portfolios. Negative market values do not indicate anything about the potential for future changes in the market values of the positions. It could in fact be quite the opposite: the larger the negative value already has become, the smaller the likelihood for a further reduction in market value might be. Changes in funding requirements are, in practice, based on the total netting between all transactions/all positions and all counterparties. SA-CCR is a measure of potential changes for individual customers/counterparties and thus only based upon a netting between derivative positions between the bank and that counterparty. Thus, an approach with SA-CCR will not take into account important netting of funding effects across all counterparties. In this context, 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.

Probably a floor based-approach would be more fit for purpose, i.e. securing that the risk of funding requirements related to derivatives are properly taken into account as the net derivative amounts might be small at a given reporting date. However, in such a case, the RSF factor needs to be appropriately calibrated, and ESBG indeed questions the reasons and background for the choice of the 20% level for this RSF.

**Question 5:** If you propose special treatment for specific activities (e.g. hedging instruments, clients clearing…), how would you define these activities?

Derivatives that are adequately secured back-to-back should be exempted from the NSFR calculations. Differences in market values due to credit spread differences should, in any event, qualify for exemption. Maturity differences do not seem to be accounted for. The 20% RSF requirement for all transactions has the effect that even positions with a very short remaining maturity will require long-term funding. Positions with a short remaining maturity, for example less than one year, should therefore be excluded from the calculations.

**Question 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?

Small and medium-sized credit institutions within the ESBG membership typically focus on regional business and are thus strongly engaged in providing SME loans. However, loan demands by larger SMEs may exceed such an institution’s individual risk-bearing capacity or may be restricted by the large exposures regime. In those cases, banks make use of syndicated loans together with other banks. The NSFR, as currently intended, restricts the provision of syndicated loans and thus the cooperation of small and medium-sized credit institutions.

ESBG would therefore like to propose that only a supervised entity’s own share of a syndicated loan should be applied to the NSFR calculation. This would entail applying a yet to be determined available stable funding (ASF) factor to the relevant share only. Such a provision would reduce the burden on smaller institutions and would strengthen SME lending.

In line with their focus on regional business activities, small and medium-sized institutions often forward promotional loans by development banks. These promotional loans significantly improve retail and SME clients’ access to funding and are a well-established practice which ensures highly informed credit decisions on behalf of a development bank. The NSFR, as currently designed, impedes the forwarding of promotional loans and thus, it negatively affects the business activities of many small and medium-sized institutions.

We therefore propose to disregard within the NSFR any assets and liabilities that arise from promotional loans. As a matter of fact, a similar provision has already been introduced to the EU’s implementation of the Liquidity Coverage Ratio (LCR). Such a provision would reduce the burden on small and medium-sized institutions and would strengthen SME lending.

In some countries, small and medium-sized institutions often cooperate within institutional protection schemes (IPSs) to realise economies of scale. IPS members voluntarily engage in liquidity balancing amongst each other. Since exposures between members of the same IPS are subject to reduced withdrawal ratios, an equal treatment with exposures of third-party institutions would not be warranted.
The NSFR, as currently intended, impedes liquidity balancing between small and medium-sized institutions within an IPS officially recognised under Art. 113(7) CRR and thus negatively affects their business activities.

Based on this, ESBG proposes to recognise deposits within an IPS as “operational deposits” and thus as ASF according to the NSFR. This classification should also apply if these deposits have maturities of less than half a year. While national competent authorities may allow an institution to apply the same ASF factor to such deposits that it applies as RSF factor to its deposits, this provision is limited to 85%. In fact, ESBG proposes to fully recognise deposits among members of the same IPS, without applying limits and irrespective of their maturity, as this would visibly stabilise the liquidity balancing of small and medium-sized institutions that have entered into an IPS.

**Question 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?

The duty to report about the stable funding profile should apply to all credit institutions on a consolidated basis. Indeed, the BCBS has designed the NSFR’s calibration on a consolidated basis, taking into account a diversification of the banking activities. An application on an individual basis could penalise banking groups which have organised some activities, such as capital market activities, within subsidiaries. It could lead to a level playing field issue. Should the NSFR be applied at solo level as well, we would recommend that a symmetrical treatment of intragroup transactions should be introduced without prior supervisory approval considering the fact that waivers are now very difficult to obtain from the ECB within the Single Supervisory Mechanism.

However, this does not necessarily mean a general application of the NSFR metric. We are of the opinion that there is some scope to make the NSFR requirements more proportionate without missing the intended purpose. The NSFR is going to induce in the banking industry an increased demand for deposits provided by retail customers and small business customers, assuming a high degree of stability of these liabilities. As a matter of fact, smaller, regional banks are primarily funded by these types of liabilities. Decreasing margins through more competition is equivalent to implementation costs of reporting duties. Hence, it is of great importance not to further penalize small, regional institutions through imposing calculation rules that measure a non-material part of their business model.

Furthermore, ESBG would like to propose that the NSFR should be calculated (and limited) only on total currency level, which would be a similar approach as it is for the LCR. Moreover, we suggest, where possible, that both ratios be defined in the same systematic and within the same frameworks so as to avoid any unnecessary burden by additional bureaucracy.

**Question 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?

Various studies\(^1\) have pointed out that the LCR and NSFR would be equivalent in case of common parameter definitions. The LCR is a complex metric requiring high implementation efforts. It should be seen in combination with the concentration metrics of the Additional Liquidity Monitoring Metrics

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\(^1\) For instance: DIW Wochenbericht Nr. 21/2016 vom 25. Mai 2016: Koenig & Pothier, „Die neue Basler Liquiditätsregulierung: Ausgestaltung und Fallstricke“.
(ALMM) as a sufficient quantitative measure for judging 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. Supervisors should have a look at the already available detailed information in the first place as long as there are no serious doubts about the stability of a bank’s funding for a 1 year horizon. This test is yet to be calibrated while also taking into account the general liquidity framework of institutions, such as being a member of an IPS and limited capital market orientation.

Please also see our comment on question 1.
About ESBG (European Savings and Retail Banking Group)

ESBG brings together nearly 1000 savings and retail banks in 20 European countries that believe in a common identity for European policies. ESBG members represent one of the largest European retail banking networks, comprising one-third of the retail banking market in Europe, with 190 million customers, more than 60,000 outlets, total assets of €7.1 trillion, non-bank deposits of €3.5 trillion, and non-bank loans of €3.7 trillion. ESBG members come together to agree on and promote common positions on relevant regulatory or supervisory matters.