ICMA EUROPEAN REPO COUNCIL

Basel Committee on Banking Supervision
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London, April 11th 2014

Dear Co-Chairs,

Response submission from ICMA ERC Committee:
Re: Basel Committee Consultative Document - "Basel III: The Net Stable Funding Ratio"

Introduction:

This letter is on behalf of the International Capital Market Association's ("ICMA's") European Repo Council ("ERC") in response to the Basel Committee on Banking Supervision's (BCBS's) Consultative Document "Basel III: The Net Stable Funding Ratio", published in January 2014.

Background to the ERC:

The ERC was established by ICMA in December 1999, to represent the cross-border repo market in Europe. It is composed of the vast majority of practitioners in this market, who meet regularly to discuss market developments in order to ensure that practical day-to-day issues are fully understood and dealt with adequately. The twice-yearly ICMA ERC General Meetings are widely attended. The ERC is committed to ensuring the establishment of a robust infrastructure to underpin the European repo market, including through the development of the Global Master Repurchase Agreement ("GMRA").

General comments:

The ERC welcomes the opportunity to respond to the BCBS on the proposed framework for this important liquidity measure. The ERC believes that consultation and constructive dialogue between regulators and key-stakeholders is essential to ensure that policy objectives are achieved, while limiting the scope for unintended consequences or counterproductive outcomes.

The ERC recognizes and understands the purpose of the Net Stable Funding Ratio ("NSFR") and is broadly supportive of its objectives, which include limiting banks' over-reliance on short-term wholesale funding and promoting stability within the banking sector. The ERC is also appreciative of the need for a simple metric that can be applied easily and consistently by the various supervisory authorities.

It is with this in mind that the ERC frames its concerns about some of the proposed treatments and calibrations relating to securities financing trades ("SFTs"), and which could cause significant disruption in the wholesale funding markets. This would have the undesirable effect of reducing liquidity and increasing risk in secondary bond markets, particularly for government securities. In turn, this would have negative implications for both investors in these securities and the issuers themselves.

The ERC believes that such market disruptions and economic impacts are not the intention of the NSFR, and accordingly makes a number of recommendations to the BCBS to help mitigate such risks, while remaining consistent with the overall objectives of the ratio. A summary of these recommendations can also be found in Annex I to this letter.

The BCBS should note that the ERC is also a signatory to a broader industry response, which outlines similar concerns regarding the treatment of SFTs and offers complimentary recommendations to those put forward by the ERC.

The nature of bank SFT activity:

The ERC has come to realize that the diverse and often complex nature of the SFT trading books of banks, and the underlying reasons for different SFT activity, are not broadly understood, and are often subject to generalizations or misperceptions. The ERC accepts that, in this respect, the industry could do more to improve general awareness and understanding of SFT markets and the different functions and activities that SFTs support[1].

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[1] A recent publication by the ICMA ERC highlights the important link between SFT markets and the real economy, and the systemic risks created from inhibiting the effective functioning of SFT markets: http://www.icmagroup.org/Regulatory-Policy-and-Market-Practice/short-term-markets/Repo-Markets/icma-european-repo-market-reports-and-white-papers/collateral-fluidity/

As the BCBS will be aware, banks transact SFTs for a variety of different reasons, and with a diverse range of counterparties. The uses of SFTs include: supporting secondary market-making; managing collateral and liquidity of both the bank and its clients (including "collateral transformation" to support the margining of derivatives trades); collateralizing secured funding transactions; hedging against settlement fails; and facilitating short-sales by both banks and clients. In all of these respects, SFTs are a critical element in the support of a bank's trading activities and the management of risks related to this.

Many of the positions in the SFT trading books of banks (commonly known as "matched-books") will be match-funded, meaning that there are offsetting repos/borrows and reverses/loans in the same security and for the same tenor (and, in the case of transactions with central counterparties, often with the same counterparty). Many matched-books, however, will also contain some non-match-funded positions, which create maturity mismatches that the SFT trading desk must manage. SFT activity that relates to secondary market-making or short-covering, in most cases, will not be part of the matched-book. Such linked transactions are often referred to as "financing trades".

In conducting SFT activities, banks will transact in a variety of underlying assets and credits, and for various tenors. However, from a fixed income perspective, most activity will be in Level 1 High Quality Liquid Assets (HQLA), and for relatively short tenors.

It should be remembered that not all banks have the same business models, and thus the mix and balance of SFT-related activities can vary widely between institutions, as well as between different markets and regions.

Preliminary market analysis related to the NSFR:

The ERC conducts twice-yearly surveys among its European based members to establish the size and composition of the European repo market, and to identify trends. The most recent survey, in December 2013[2], values market outstandings at €5.5 trillion. This is a contraction from €6.1 trillion in June 2013, and contrasts with a peak of €6.8 trillion in June 2008. It is estimated that the survey captures around 80% of the European repo market.

While the survey does focus on collateral types and tenor, it does not break down counterparty type into the same entities as those used in the NSFR framework. Thus, the data required to conduct a detailed impact analysis of the proposed NSFR required stable funding ("RSF") and available stable funding ("ASF") calibrations is not readily available. The ERC, therefore, conducted a "snap survey" in early 2014 with the goal of better assessing the likely impact of the proposed NSFR framework for the European repo market[3]. Given the limitations of time, this was never intended to be the thorough and rigorous quantitative impact study that the appropriate calibrations of the NSFR require. However, it does provide a useful indication of the proportion of the market that could be impacted.

A summary of the survey results and some of its key conclusions are provided in Annex II to this letter.

[2] http://www.icmagroup.org/Regulatory-Policy-and-Market-Practice/short-term-markets/Repo-Markets/repo/latest/

[3] The ERC is aware that separate analysis is being conducted by others representatives covering the US and Japanese markets. The focus of the ERC analysis is specifically on the European repo market.

Of most significance is the relative importance of reverse-repos of tenors under six-months with non-bank financial institutions (NBFIs)[4], as highlighted by the data. The survey suggests that this is around 35% of all sub-six-month reverses. Extrapolating from the December 2013 survey, this would imply an outstanding stock of reverse repo transactions with NBFIs with a market value in the region of €1.4 trillion. In terms of the flow of transactions over the period between surveys, the value would be very much larger.

Of these outstandings in sub-six-month reverse-repos with NBFIs, the survey suggests that some 70% is against Level 1 HQLA (or almost €1 trillion).

The ERC feels that these numbers are significant, and underlie its concerns related to the market impact of the NSFR, particularly those arising from the proposed RSF and ASF factors applicable to SFTs with NBFIs.

Secured funding and collateral quality:

The ERC recognizes that the asymmetry in the framework for ASF and RSF factors applicable to loans with NBFIs is deliberate, and is intended to reduce bank reliance on short-term funding from these institutions, as well as ensuring that any short-term loans to NBFIs carry a substantial haircut. However, the ERC would expect the framework to distinguish between secured and unsecured lending arrangements, not least when secured lending arrangements in the form of SFTs, as described already, crucially support a variety of bank functions and trading activities.

The ERC would point to the fact that, in most instances, not only can securities received in SFTs be liquidated by the lending institution in the event that the counterparty defaults on their loan, but that these securities can also be used by the lending institution to generate liquidity during the term of the loan. This is particularly pertinent in the case of SFTs transacted under the Global Master Repurchase Agreement (or "GMRA" and that is the market standard repo contract used in Europe), which facilitates the legal transfer of title of underlying assets, thus effectively limiting encumbrance[5].

Whether securities used to collateralize secured funding arrangements are liquidated in the event of default, or used to raise liquidity during the tenor or the SFT, the quality and liquidity of these securities is a critical consideration. Calibrating for this would also be consistent with other Basel III liquidity measures.

While the ERC can appreciate the reasoning behind the BCBS's proposal for a 50% RSF weighting for unsecured loans to NBFIs with maturities of one year or less, it does not believe that this is relevant for secured loans, particularly when secured with the most liquid and highest rated assets.

[4] For the purpose of this analysis, the ERC defines NBFIs as financial institutions other than banks, broker-dealers, central counterparties (CCPs), and central banks.

[5] In relation to the GMRA, any encumbrance arising out of repos tends to be marginal, and relates to: (i) haircuts applied to repos – the over-collateralized portion of the transaction can be considered as encumbered; and (ii) contingent encumbrance – related to the potential credit and liquidity risk of selling the underlying asset at a price below the value of the repo including any haircuts and variation margining. This is explained in an ICMA ERC briefing paper on asset encumbrance.

Accordingly, the ERC is supportive of the broader industry recommendation that in the case of secured loans of maturities of twelve months or less to non-bank entities, where the underlying securities are Level 1 HQLA, the appropriate RSF factor is 0%.

For secured loans against all other underlying securities, the ERC supports the recommendation that an RSF factor be applied that is equal to the product of 50% and the RSF factor that would apply to the collateral if held by a bank as an unencumbered asset.

Counterparty definitions:

The ERC is concerned by some of the counterparty definitions used in the framework, particularly where they are subject to different ASF or RSF treatments, and where any anomalies or a lack of clear definition could result in and uneven playing-field. Many central counterparties (CCPs), for instance, are not banks. Applying the asymmetrical treatment for loans to CCPs would be a deterrent to the centralization of repo market clearing and provide a strong incentive for inter-bank bilateral repo trading.

The ERC feels that it is therefore important to broaden the category of banks not only to include qualified central counterparties ("QCCPs") and broker-dealers, but to all financial institutions that are subject to prudential regulation for liquidity and capital.

Thus, in its calibrations for ASF and RSF weightings, the NSFR would draw a distinction between financial institutions that are subject to prudential regulation and those that are not, which the ERC feels is more consistent with the objectives of the ratio.

The ERC would also expect central banks to be included in the definition of financial institutions subject to prudential regulation (even if, technically, they are not). As the BCBS will realize, applying asymmetric ASF and RSF treatments to SFTs with central banks could have serious ramifications for the effective conduct of monetary policy. Furthermore, central banks are often active counterparties in SFT markets beyond the scope of monetary policy operations, and can act as principal, custodian, or intermediary in a variety of SFT activity.

SFTs linked to outright trades:

As discussed, many SFTs are transacted to support the crucial functions of secondary market-making, covering short-sales (which can be part of hedging strategies)[6], or to hedge against settlement risk. While the ERC does not have data on which to build an accurate estimate of the amount of SFT activity as a percentage of the total that supports these functions, it is likely to be significant. Furthermore, these SFTs mostly have very short tenors and will be transacted with a variety of bank and non-bank counterparties. While more analysis is required, the ERC would expect that a large portion of the reverse-SFT activity with NBFIs reported in the survey would be linked to such trading and hedging activity, facilitating the financing of bank or client short positions.

[6] Which is consistent with the European Securities and Markets Authority regulations on short selling.

If a 50% RSF factor is applied to reverse-SFTs that are used to finance bank and client shorts, the incremental costs to the transaction arising out of the additional long-term funding requirement will be onerous. Annex III illustrates the impact on such SFTs. For example, in the case of an overnight reverse-SFT in a German government bond as of today, the inter-bank market bid would need to be increased by an estimated 85%[7] if the source of the securities is a NBFI. For longer term SFTs, the adjusted repo-rate for NSFIs would more than double. This additional cost would, in most cases, render these types of transactions economically unviable.

Given the significant volume of short-dated reverse-SFTs with NBFIs, it would seem reasonable to assume that this would create a significant financing gap for secondary market-making and hedging activities, as institutions classified as non-banks under the NSFR would no longer be able or willing to lend securities. If dealers and clients find it more difficult and more expensive to cover their short positions, then this will translate to thinner liquidity and wider spreads in secondary bond markets. In turn, this will heighten risks for investors, and increase borrowing costs for issuers. Hardest hit will be government debt issuance, to which, as the survey would suggest, at least in Europe, the majority of SFT activity is linked.

The ERC supports the broader industry recommendation that reverse-SFTs with non-banks that are linked to the financing of bank or client short positions, regardless of asset type or tenor, be exempt from the RSF applicable to loans to non-banks.

Concluding remarks:

The ERC believes that while sound regulation and liquidity measures are desirable goals, these need to be balanced with the requirement for liquid and stable capital markets that help underpin the health of the real economy. SFT markets play a critical role in ensuring this liquidity and stability, and a significant portion of this activity is transacted between banks and non-banks in the most liquid and highly rated collateral. The ERC is concerned that the current framework for the NSFR directly threatens this segment of the market, which would be hugely disruptive for the effective functioning of wholesale funding markets, and destabilizing for capital markets.

While the ERC offers and supports a number of recommendations and amendments to improve the framework, it still firmly believes that there is a compelling case for more in-depth, rigorous analysis of the potential consequences of the NSFR for global capital markets and the likely impact of this on different economies. This should ultimately be the basis for determining the appropriate calibration of ASF and RSF factors across different assets, counterparty types, and tenors. The ERC would encourage the BCBS to lead such a quantitative market impact study and economic impact analysis, with the full engagement of market participants and relevant stakeholders, including investors, fund managers, and corporate and public sector issuers. The ERC would be appreciative to play its part in supporting such an initiative.

Once again, the ERC would like to thank the BCBS for providing the opportunity to respond to the proposed framework for the NSFR, to share comments and concerns, and to offer recommendations

[7] As explained in Annex III, the actual cost impact will vary depending on the cost of long-term funding for different banks, as well as their capital and funding structures.

designed to support the successful realization of the NSFR objectives, while mitigating the risk of unintended outcomes. Further to this, the ERC would be grateful for the chance to meet with the BCBS at the earliest opportunity to discuss these concerns and recommendations in person.

In the meantime, should the BCBS have any questions regarding the comments and recommendations outlined in this letter, please do not hesitate to contact us.

Yours faithfully,

Godfried De Vidts
Chairman
ICMA European Repo Council

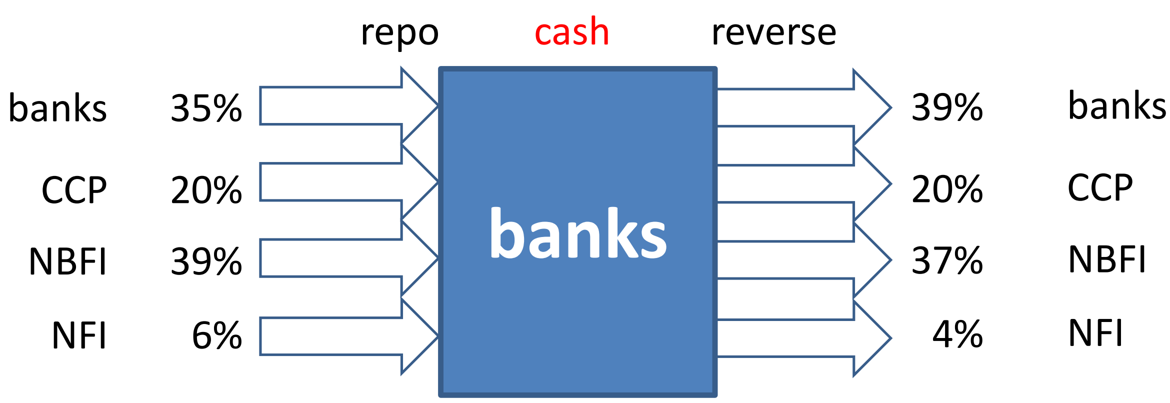
Annex I: Summary of recommendations to mitigate risks from the proposed NSFR framework

Identified risk	Recommendation to mitigate risk
The proposed schedule for RSF factors relating to loans does not recognize the inherent benefits of secured over unsecured funding or the access to liquidity that the underlying assets in secured lending provide.	▪ Secured loans of maturities of twelve months or less to non-bank entities, where the underlying securities are Level 1 HQLA, receive an RSF factor of 0%. ▪ For secured loans of maturities of twelve months or less to non-bank entities, where the underlying securities are not Level 1 HQLA, the appropriate RSF is the product of 50% and the RSF factor that would apply if held by the bank as an unencumbered asset.
The counterparty definitions used in the NSFR framework may lead to the adverse asymmetric treatment of critical providers of liquidity and stability in SFT markets. This would include qualified central counterparties, broker-dealers, and central banks.	▪ The category of banks in the NSFR framework be broadened to include all financial institutions that are subject to prudential regulation for liquidity and capital, as well as central banks.
Non-banks are a critical source of securities in the SFT markets to facilitate secondary market-making, short-covering (which can be part of hedging strategies), or hedging against settlement risk. Restricting this supply of securities would seriously undermine liquidity and stability in securities markets.	▪ Reverse-SFTs with non-banks that are linked to the financing of bank or client short positions, regardless of asset type or tenor, receive an RSF factor of 0%.
The potential impacts of the proposed NSFR framework on global funding and capital markets, as well as the real economy, have not been sufficiently assessed.	▪ A thorough and detailed quantitative impact study and economic impact assessment be conducted to determine the likely effects of the NSFR across global capital markets, and on the various economies where it will be applied. This should engage the BCBS, relevant supervisory authorities, market participants, and market users, including investors, fund managers, and corporate and public sector issuers. This should ultimately form the basis for determining the appropriate framework and optimal calibrations of the NSFR.

Annex II: Europe-wide survey of reverse repos potentially subject to NSFR RSF factor of 50%

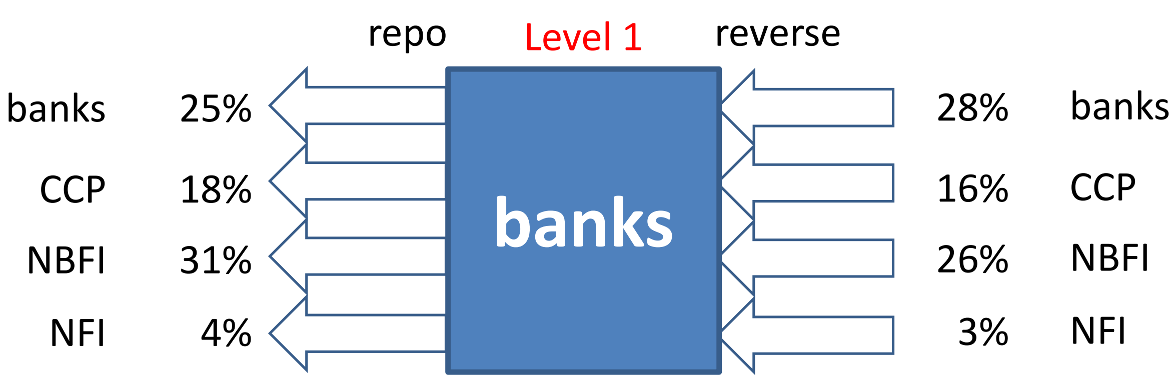
The ICMA undertook a survey of the breakdown of reverse repos and repos by banks with terms of six months or less classified by type of counterparty. Returns were received from 20 banks, who account for some 51% of the December 2013 ICMA European Repo Market Survey total. Reporting dates range from 31 December to 28 March.

The results are summarised in the diagram below. This shows that about 37% of short-term (six months or less) reverse repo were with non-bank financial institutions (NBFIs). This business is worth EUR 570 billion. Extrapolating from our sample on the basis of a conservative assumption that the semi-annual ICMA survey captures about 80% of the European market, the total amount of reverse repo between banks and NBFI in the European market is estimated to be about EUR 1.4 trillion.



However, these averages disguise a very wide variation in business models. Thus, the proportion of reverse repos that sample banks do with NBFIs varies from zero to 64%.

The next chart summarises the flows of collateral in short-term reverse repos and repos against Level 1 HQLA. Some 70% of short-term reverse repos and 78% of short-term repos with NBFIs are against such collateral.



Supplementary survey suggests that about 5% of reverse repos and 14% of repos with NBFIs are in fact with central banks (not for monetary policy operations) and multilateral development banks.

Annex III: The impact of the NSFR on the cost of NBFI reverse repo

An approximate attempt to cost the impact of the NSFR can be done by calculating the carrying cost of covering the stable funding deficit with term funding (at least 12-month borrowing) and adding the cost to the bid/offer spread of the matched-book dealer. The calculations are set out in the table below for reverse repos to non-bank financial institutions in German Government "General Collateral" of 1 to 181 days funded with unsecured 12-month funding (proxied by the cost of 2-year senior unsecured debt for an A-rated bank).

		Tenor	Repo Rate	Break-even increase in bp	Adjusted Repo Rate	Increase in % terms
12mth Funding	0.62%	1 day	0.23%	0.20%	0.43%	85%
RSF Factor	50%	7 days	0.23%	0.20%	0.43%	85%
		14 days	0.23%	0.20%	0.43%	85%
		31 days	0.21%	0.21%	0.42%	98%
		91 days	0.18%	0.22%	0.40%	122%
		181 days	0.15%	0.24%	0.39%	157%

The calculation could be done on the assumption that the stable funding deficit was funded with equity. This would considerably increase the cost.