

August 9, 2016

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Washington, D.C. 20551

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Re: Notice of Proposed Rulemaking - Net Stable Funding Ratio: Liquidity Risk Measurement Standards and Disclosure Requirements

Docket No. R-1537, RIN 7100-AE51

Ladies and Gentlemen:

Deutsche Bank is grateful for the opportunity to comment on the joint notice of proposed rulemaking of the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency and the Board of Governors of the Federal Reserve System, which seeks to implement the Basel Committee on Banking Supervision's ("BCBS") Net Stable Funding Ratio ("NSFR") requirement in the United States.

A properly designed NSFR is a very useful part of the regulatory toolbox. While the Liquidity Coverage Ratio ("LCR") ensures sufficient liquidity resources are in place to survive a short-term stress scenario, the NSFR acts as a business as usual measure. This ensures banks fund their balance-sheets appropriately; not taking undue liquidity risk and ensuring less-liquid balance sheet items are appropriately funded with stable funding.

The NSFR will have a material impact on banks' liquidity management, funding structure and business strategy. Prioritizing simplicity, while implementing this measure without taking into consideration risk sensitivity, may lead to unintended and undesirable impacts such as significantly decreasing market liquidity for securities, notably High Quality Liquid Assets ("HQLA"), and other equities; impeding the availability of essential risk hedging services to derivatives users, such as pension funds and corporations; and reducing listed equities value through the application of severe haircuts. The impact of these changes will be felt not only by banks, but also by their clients. We believe that finding simple solutions that consider risk sensitivity and maintain comparability while accurately representing the funding-risk the standard aims to capture, is the way to meet the stated regulatory objectives.

It is also important to reiterate that the NSFR is intended to be a structural measure that assesses a bank's capacity to provide long-term financing and it is important that this intended policy objective is ensured during the Agencies implementation of this regulatory measure. Calibrating the NSFR in an overly conservative way has a direct impact on a bank's balance sheet and ability to provide long-term financing and short-term liquidity to the real economy.

In summary we believe that are five key areas that the Agencies should either clarify or amend, when finalizing the US rulemaking on the NSFR:

- **Derivatives:** We urge the Agencies to recognize HQLA variation margin received as eligible for netting against the replacement cost of derivative assets. Furthermore, we strongly suggest the Agencies undertake a thorough impact analysis before introducing a stable funding requirement for potential future changes in the value of a covered company's derivatives portfolio.
- **Reverse Repurchase Agreement ("Repo"):** The potential detrimental impact of the BCBS NSFR framework on repo markets, and for market liquidity in general, is concerning. We question the need for the asymmetrical approach (10-15% RSF) on short-term repo markets, which provide vital market liquidity and support the liquidation of HQLA in a stress scenario.
- **Short Coverage:** Client and firm shorts, which attract no stable funding value in the standard, require 10-15% RSF where the bank covers the position by reversing in the stock sold short. The execution of long and short positions in the market, which crucially contributes to market liquidity and efficient capital markets, is at risk from the punitive approach taken in the standard.

- **Client Exposure to Securities:** Banks perform a vital market-making function by purchasing and selling inventories of securities, mainly equities. Punitive long term financing rates applied to short term market making businesses will have knock on impacts to the economic viability of servicing clients who require access to the equities markets.
- **Treatment of Rehypothesized Off-Balance Sheet Assets:** We urge the Agencies to clarify the meaning of section 106(d) of the proposed rule, which appears to be a clear extension of the BCBS framework. In particular, section 106(d)(3) would seem to suggest that off-balance sheet collateral, such as securities margin associated with derivatives transactions, that has been re-used in a subsequent transaction, requires further stable funding. Such treatment would be extremely punitive and could lead to multiple unintended consequences.

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We hope that these comments will be helpful in the finalization of the rules on the NSFR. We would be happy to discuss any of the topics covered here in more detail

Respectfully submitted,



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ANNEX to Deutsche Bank's Comment Letter Dated August 9, 2016

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1. Calibration of the derivatives funding requirement

The introduction of the derivatives funding requirement, in accordance with the proposed rulemaking would likely lead to increased cost to real-economy end-users. For example pension funds require exposure to interest rate swaps to hedge the volatility that can arise from their securities and investments, or exposure to inflation swaps to manage the mismatch between their assets and liabilities; an activity which is vital for securing returns on pension fund investments and securing the future income of scheme members.

The ability of these real-economy end-user clients to absorb these costs is limited. Of particular concern is the likelihood that these firms will begin to take on more risk due to increased cost, rather than the current practice of hedging their risk. Accordingly, we urge the Agencies to reconsider the treatment of derivatives within the NSFR regarding: (i) HQLA securities variation margin; and (ii) potential future changes in the value of a covered company's derivatives portfolio.

HQLA securities variation margin: Under section 107(f) of the proposed rulemaking which de-recognizes securities variation margin received regardless of asset quality, disadvantages end-users who do not have cash collateral to post as variation margin. There are a certain set of end-users, such as pension funds and other asset managers, who have no choice but to post securities collateral as variation margin, as cash is either difficult to obtain (e.g. would require repo financing) or costly to hold. This treatment will lead to increased costs of business for these counterparties because they will need to either reserve more cash, forgoing higher yielding assets, or enter into repo transactions to receive cash; a transaction which is not without cost.

In addition to the impact this calculation will ultimately have on end-users, the de-recognition of rehypothecable HQLA could have detrimental impacts on the market liquidity of these asset classes, by simply contributing to reduced demand for this asset class (e.g. by making it more favorable to hold cash rather than securities). The detrimental effect of de-recognizing HQLA collateral on market liquidity for these assets is currently unknown.

We urge the Agencies to recognize securities variation margin received, as eligible for netting against the replacement cost of derivative assets, where the securities received meet the definition of HQLA in the LCR rule. An appropriate liquidity haircut could be applied, (e.g. 5% for US Treasuries to 50% for major index equities, for additional prudence).

Potential future changes in the value of a covered company's derivatives portfolio: The Agencies outline the need for a covered company to assign stable funding, equal to 20 percent of the sum of the covered company's gross derivatives liabilities values, to support "potential variation margin and settlement payment outflows".

The approach outlined for achieving this objective within the proposed rule, is crude and leads to an add-on significantly exceeding the observable historical value of additional collateral posted, including under severe stress. We challenge the need for this add-on within the NSFR, at all, which is a business as usual funding metric and should not take account of future market changes. The risk that a covered company incurs additional collateral outflows in a stress scenario is already captured by the LCR.

We understand the Agencies are considering alternative methodologies for capturing the potential future changes in the value of a covered company's derivatives portfolio. Before determining whether any stable funding is required for this particular objective, we strongly suggest the Agencies conduct a thorough impact analysis by way of an observation period. In light of the numerous options which require further consideration, and the absence of any concrete data on the potential future impact to the US economy, we suggest further time is required to.

2. Reverse repo:

The proposed rulemaking introduces an asymmetrical treatment between short term (<6 months) repurchase agreements (0% ASF) and reverse repurchase agreements (10-15% RSF). The potential detrimental impact of this treatment on repo markets, and for market liquidity in general, is a matter of concern. First, the government bond repo market is very price elastic and regulation such as the Leverage Ratio has already reduced the size of this activity substantially since the crisis as evidenced by the evolution of repo trading volume between 2007 and 2015 as per the table below showing data compiled by the International Capital Market Association (ICMA).

Evolution of Repo Trading Volume	
Total Repo business June 2007 ⁸	EUR 6,775bn (47.5% repo/52.5% reverse repo)
Total Repo business Dec 2015 ⁹	EUR 5,608bn (50.8% repo/49.2% reverse repo)

Second, it is vital that market liquidity is available on an ongoing basis for HQLA. As specified in the Agencies final rulemaking on the LCR, covered companies must have the operational capability to monetize assets for inclusion as eligible HQLA; this includes the ability to access reverse repurchase agreements. We believe that the introduction of the NSFR, which will require long term funding to be held against reverse repo activity on HQLA assets (however low the 10% proposed coefficient may appear), will directly impact the size and availability of the repo market for these assets. This would run counter to the prudential aim of liquidity regulation, which requires banks to keep large volumes of liquid assets on reserve in the event they need to be liquidated in a stress scenario.

The potential for a market-wide stress scenario would be particularly concerning. Multiple institutions, hoping to simultaneously liquidate portfolios of assets during a market-wide stress event, may find this extremely difficult due to the high RSF requirement for counterparties on the other side. The ability of the financial system to respond to a severe liquidity scenario could, therefore, be significantly impeded by the NSFR. This would ultimately lead to increased risk in the system and higher costs transmitted to the real economy, due to the inability of financial counterparties to fulfill their intermediation function.

We suggest that, as short term securities financing is vital to market liquidity, the long term funding requirement envisaged within the proposed rulemaking should be revised to 0% RSF.

3. Short coverage:

The execution of long and short positions in the market crucially contributes to market liquidity and efficient capital markets. Client and firm shorts, the latter of which is usually driven by a client facing transaction, attract no stable funding value in the standard, yet require 10-15% RSF where the bank covers the position by reversing in the stock sold short. This is in direct contrast to the LCR which treats this transaction as risk neutral. Furthermore, the asset (e.g. the reverse repo) and the liability (e.g. the short position) co-exist and largely have the same short-term duration. By significantly increasing the transaction cost for short coverage, the current NSFR proposal could impede market liquidity further, once the standard is implemented.

The impact of banks receding from short-sale facilitation, as a result of NSFR implementation, on the market liquidity for underlying stock, can be observed from the impact of past regulatory bans on short sales. For example, “the 2008 short-sale ban in the United States was associated with a 32 basis point increase, on average, in relative effective bid-ask spreads for the banned stocks. For the 404 financial stocks that were subject to the ban for its duration—September 18 through October 8, 2008 the increase in spreads represents an increase in liquidity costs of more than \$600 million”¹.

Consistent with our comments on reverse repo, we suggest that the long term funding requirement envisaged within the proposed rulemaking should be revised to 0% RSF.

4. Client exposure to securities:

Clients seek exposure to securities, and in particular equities, for a variety of economic reasons. For example, pension funds and asset managers invest in ISDA documented derivative equity exposures to support investment mandates. Banks offer clients exposure via derivative swaps, and purchase equities as a market risk hedge. This financing of client equities positions is critical to the efficient and profitable functioning of the equities markets.

The bank offering the exposure must hedge the market risk by an equal and off-setting transaction. In most instances, this relies on the bank purchasing the security on the balance sheet, as “own inventory”, attracting a 50-85% RSF under the current rules. The current calibration of the funding requirement for equity hedges to client derivatives does not adequately factor in the underlying duration of the derivative and business that is being hedged, which is generally much shorter than suggested by the NSFR framework. For example, a security hedging an overnight derivative would currently be required by the standard to be funded in the same manner as a security hedging a five year derivative.

The bank does not generally take price risk on client hedges as legally binding contractual arrangements and operational processes are in place to ensure the sale of the assets can be achieved before the client derivative is settled, which allays fears of being left with assets when the client has ceased to do business. In almost all

¹ Page 6: https://www.newyorkfed.org/medialibrary/media/research/current_issues/ci18-5.pdf

instances, the derivatives are daily margined to protect against credit risks arising from price risk in volatile markets and initial margin is exchanged to protect against severe market moves. When the client closes-out their position, the bank will sell the position immediately to rebalance the market risk hedge. There are legal and structural provisions in place to ensure that price volatility is absorbed by the clients cash close-out.

Banks typically provide this service to end-users in two distinct transactions, fully funded and partially funded swaps. Under the fully funded model, the client funds the exposure to equities via cash margin posted to the bank. Under the proposed rule, covered companies would receive no ASF value for the funding provided by the client, despite the fact it is intrinsically linked to the asset. This approach is extremely punitive as the covered company is required by the proposed rule, to fully fund the purchase of the hedge (e.g. 50-85% RSF).

In instances where a client provides full funding in the form of cash margin we ask that the Agencies recognize the duration of the liability as inherently equal to the duration of the hedge asset purchased and assign 0% RSF. In instances where a client has not fully funded the purchase of the underlying hedge, we urge the Agencies to reconsider the punitive 50-85% stable funding requirement, considering the short-term nature of these structures.

5. Treatment of rehypothecated off-balance sheet assets:

We wish to point out that section 106(d) of the proposed rulemaking is unclear and covered companies could benefit from additional guidance on this provision. With respect to section 106(d)(1), we understand that banks will be required to “encumber” a lending transaction, where the off-balance sheet security received as part of the lending transaction has been re-used (in a borrowing transaction for example), for the maximum of either the remaining maturity of the lending transaction or the period for which the asset has been rehypothecated.

Second, section 106(d)(2), which applies to asset exchanges, would appear to do the same (e.g. the period of encumbrance which applies to the asset posted, must be set for the maximum of either the remaining maturity of the asset exchange or the period the asset received has been rehypothecated). While this treatment might intuitively make sense, as it follows the logic of section 106(d)(1) with respect to reverse repos, the fundamental issue is that asset exchanges are not accounted for within the NSFR ASF framework.

Asset exchanges, where a covered company is upgrading lower quality assets for higher quality HQLA, receive full value in the LCR if maturing beyond thirty days. For example, if RMBS (Level 2B) is exchanged for

US Treasuries (Level 1) for greater than one year, this would receive 0% outflow in the LCR and the Treasuries would be recognized as Level 1 in the covered companies stock of HQLA. In the NSFR however, the collateral lent (in this example, RMBS) is considered “encumbered” for more than one year requiring 100% long term funding, and no funding value is assigned to the Level 1 asset received, even where the asset is eligible as HQLA. This incentivizes banks to reuse the asset received in the asset exchange, for instance in a repurchase agreement for greater than one year (receiving 100% ASF). This additional re hypothecation potentially increases systemic risk.

To support these transactions, which in turn support the market liquidity of assets, we recommend the Agencies reflect the appropriate value is reflected in the NSFR, while respecting the BCBS NSFR maturity buckets and encumbrance framework. Our recommended ASF values are depicted in the following table².

	Amount					
	< 6 months		≥ 6 months to < 1 year		≥ 1 year	
	Market value of collateral lent RSF	Market value of collateral borrowed ASF	Market value of collateral lent RSF	Market value of collateral borrowed ASF	Market value of collateral lent RSF	Market value of collateral borrowed ASF
Collateral swaps in which:						
Level 1 assets are lent and Level 1 assets are borrowed, of which:	0.05	0.00	0.50	0.45	100.00	0.95
Level 1 assets are lent and Level 2A assets are borrowed, of which:	0.05	0.00	0.50	0.35	100.00	0.95
Level 1 assets are lent and Level 2B assets are borrowed, of which:	0.05	0.00	0.50	0.00	100.00	0.50
Level 1 assets are lent and other assets are borrowed, of which:	0.05	0.00	0.50	0.00	100.00	0.00
Level 2A assets are lent and Level 1 assets are borrowed, of which:	0.15	0.00	0.50	0.45	100.00	0.95
Level 2A assets are lent and Level 2A assets are borrowed, of which:	0.15	0.00	0.50	0.35	100.00	0.95
Level 2A assets are lent and Level 2B assets are borrowed, of which:	0.15	0.00	0.50	0.00	100.00	0.50
Level 2A assets are lent and other assets are borrowed, of which:	0.15	0.00	0.50	0.00	100.00	0.00
Level 2B assets are lent and Level 1 assets are borrowed, of which:	0.50	0.00	0.50	0.45	100.00	0.95
Level 2B assets are lent and Level 2A assets are borrowed, of which:	0.50	0.00	0.50	0.35	100.00	0.95
Level 2B assets are lent and Level 2B assets are borrowed, of which:	0.50	0.00	0.50	0.00	100.00	0.50
Level 2B assets are lent and other assets are borrowed, of which:	0.50	0.00	0.50	0.00	100.00	0.00
Other assets are lent and Level 1 assets are borrowed, of which:	0.85	0.00	0.85	0.45	100.00	0.95
Other assets are lent and Level 2A assets are borrowed, of which:	0.85	0.00	0.85	0.35	100.00	0.95
Other assets are lent and Level 2B assets are borrowed, of which:	0.85	0.00	0.85	0.00	100.00	0.50
Other assets are lent and other assets are borrowed	0.85	0.00	0.85	0.00	100.00	0.00
Total outflows and total inflows from collateral swaps						

Table 1: Recommended Treatment of Asset Exchanges³

Finally, section 106(d)(3) refers to scenarios in which a covered company has reused assets “that it did not obtain under either a lending transaction or an asset exchange”. Any attempt to add additional stable funding for

² Please note: no adjustment is required for collateral downgrade transactions (highlighted in red) as these transactions are already penalized by the current NSFR encumbrance framework, which ensures they receive the highest RSF, appropriate for the term of the transaction. Transactions highlighted in amber are asset exchanges where the collateral posted and received is of equal HQLA value. The ASF value, suggested in this example, simply re-sets the RSF to the default RSF within the NSFR asset framework. For example, a Level 1 for Level 1 swap maturing in six months would receive 50% RSF (encumbered for six months), therefore the ASF value for the collateral received should be 45%, returning this transaction to the default RSF of 5% for a level 1 asset (50% RSF – 45% ASF = 5% RSF).

³ Using BCBS QIS template definitions from the Liquidity Coverage Ratio report

the re-use of off-balance sheet assets, not received in a lending transaction or asset exchange, represents a departure from the BCBS framework. We strongly urge the Agencies to reconsider both the need, and intended scope, of this requirement.

6. Maturity assumptions:

Section 101 of the proposed rules requires “a covered company to take the most conservative approach when determining maturity with respect to any notice periods and with respect to any options, either explicit or embedded, that may modify maturity dates”. While it is noted that this approach is consistent with the Agencies rulemaking on the LCR, within the NSFR this represents a departure from paragraph 18 of the BCBS standard, which states that a more detailed assessment should be made, taking into account: (i) reputational factors that may limit a bank’s ability not to exercise the option and (ii) whether the market expects certain liabilities to be redeemed before their legal final maturity date. This assessment does not lead to the automatic treatment of the liability according to the earliest possible maturity date, in all scenarios, but takes a more risk sensitive approach to determining maturity.

7. Buy-back assumptions

Question 14 of the Agencies NPR asks “Should long-term debt securities issued by a covered company where the company is the primary market maker of such securities be assigned an ASF factor other than 100 percent (such as between 95 and 99 percent) to address the risk of a covered company buying back these debt securities?”. We wish to reiterate that the NSFR is not intended to be a stress metric and therefore, no such adjustment should be necessary for potential buy-backs of the covered company’s liabilities.

8. Credit and Liquidity Facilities

The proposed rule, which assigns 5% RSF to undrawn commitments, should mirror the treatment of commitments under the LCR rule by permitting a Covered Company to take into account HQLA eligible collateral that is received by the Covered Company to secure its commitment.

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