

## MEMORANDUM

**TO:** Public File - Notice of Public Rulemaking: Net Stable Funding Ratio: Liquidity Risk Measurement Standards and Disclosure Requirements (RIN 3064-AE44) (“NSFR NPR”)

**FROM:** Sue Dawley, Senior Attorney, Legal Division

**DATE:** November 15, 2016

**SUBJECT:** Meeting with Representatives from the International Swaps and Derivatives Association, Inc. (“ISDA”)

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On November 1, 2016, FDIC staff, along with the staff of the Office of the Comptroller and the Board of Governors of the Federal Reserve System, met with representatives of ISDA.

Representatives from ISDA presented their concerns and views with regard to certain provisions of the NSFR NPR, which was issued in the Federal Register of 81 FR 35124 (June 1, 2016), including the impact of the NSFR NPR on the treatment of initial and variation margin and derivatives, and presented the attached information.

The FDIC representatives at this meeting were:

- Eric Schatten, Senior Policy Analyst, Division of Risk Management Supervision
- Nana Ofori-ansah, Policy Analyst, Division of Risk Management Supervision
- Greg Feder, Counsel, Legal Division
- Andy Williams, Counsel, Legal Division
- Sue Dawley, Senior Attorney, Legal Division

Representatives from ISDA in attendance at the meeting were:

- Anna Shender, Managing Director, Enterprise Capital Management, Regulatory Policy, Bank of America
- Damian Harland, Managing Director, Head of Treasury Regulatory Strategy, Barclays
- Carlos Mendez, Vice President, Corporate Treasury/Capital Planning, Citi
- Andreas Glaser, Vice President, Corporate Treasury, Goldman Sachs
- Matt Ekberg, Senior Policy Advisor for Regulatory Affairs, Institute of International Finance
- Ann Battle, Counsel, ISDA
- Matt Cameron, Assistant Director, European Public Policy, ISDA
- Mark Gheerbrant, Head of Risk and Capital, ISDA
- Andrew Nash, Executive Director, Legal Department, Morgan Stanley

# Net Stable Funding Ratio – Derivatives Issues



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## **20% RSF for Derivatives Liabilities**

## 20% RSF for Derivatives Liabilities

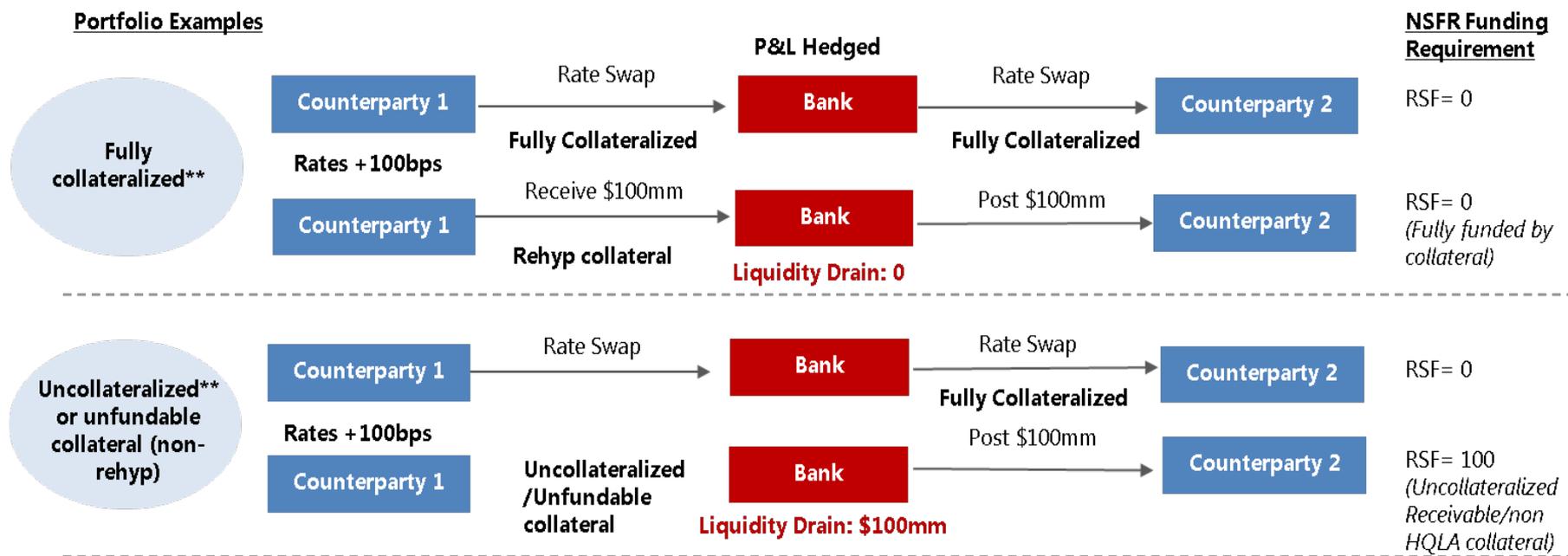
The 20% RSF on derivatives liabilities does not incentivise managing derivatives volatility and does not appropriately capture funding risk. The requirement may result in an additional funding burden of €340 billion (\$377 billion) across the industry.

- The measure was not included in any BCBS NSFR consultative document prior to appearing in the final standard and hence the industry did not have an opportunity to comment on it.
- The measure is supposed to capture contingent liquidity risks. However, such risks related to derivatives MTM movements are already in part captured by the LCR - a stressed measure whose buffer is designed to be drawn down in times of stress. The NSFR is not designed as a stress-based ratio but is instead a requirement designed to ensure that banks fund their activities with sufficiently stable sources of funding.
- Furthermore, we believe the size of a gross payable on a bank's balance sheet is an inappropriate indicator of a firm's market contingent funding requirements as it is not related to (i) the collateral a firm is required to post to secure its derivative liabilities, (ii) the rehypothecable cash and liquid securities collateral a firm receives from other counterparties to secure its derivative assets, or (iii) the volatility associated with different types of derivatives.
- We believe that it does not address some key elements of derivative pledge sensitivity and therefore cannot be practically translated into product pricing and trading actions. In particular:
  - i. Gross figures do not address the fact that only collateralized trades will drive contingent funding needs;
  - ii. Static NPV positions cannot reflect the sensitivity of one portfolio versus another; and
  - iii. There is no temporal aspect which would justify raising long term funding against short term maturing trades.

# 20% RSF for Derivatives Liabilities

- The NSFR 20% add-on contemplates a stable funding requirement for the risk that market moves could increase the funding requirement of a derivatives portfolio
- While P&L market risk from derivatives is captured in capital requirements and derivative portfolios are generally hedged, the margining terms of a derivatives portfolio could create market volatility for the funding requirement of a portfolio

## Portfolio Examples



\*\*'Fully collateralized' means MTM changes are fully offset by variation margin. This also applies to cases where the MTM is settled (i.e. a settlement payment).

\*\*'Uncollateralized' means MTM changes are not fully offset by variation margin (this includes instances where collateral agreements include thresholds).

\*\*'Unfundable collateral' means variation margin is exchanged but the receiving counterparty is not permitted to rehypothecate the collateral.

# 20% RSF for Derivatives Liabilities

## What is the potential impact of the requirement?

- The potential additional funding burden of €340 billion translates into an additional annual funding cost of €6.7 billion (see QIS).

## Industry Recommendations

- We believe that a more risk-sensitive measure should be used to capture potential long-term future funding needs.
- Given the 20% RSF measure has never been fully assessed and impact tested, nor have any alternatives been adequately evaluated, we believe it is crucial that the Agencies defer the adoption of a measure until they have been able to fully assess and observe the potential impacts of different alternatives. To this end we believe that the Agencies should re-propose this aspect of the proposed ruleset.
- We believe the Agencies should consider in their analysis methodologies including, but not limited to an appropriately calibrated PFE approach, HLBA and a floor. The industry has not had sufficient time to explore the suitability of the methodologies, and we aim provide additional considerations and analysis as to their appropriateness over the coming months.
- We also believe that under any such measure, settlement payments should not be grossed up. Settlement payments extinguish all or part of exposures to counterparties should not be disincentivised. Moreover, this requirement was not included in the final Basel NSFR text.

# 20% RSF for Derivatives Liabilities

## Possible alternative methodologies that require further consideration

### **Potential Futures Exposure (PFE): Approach**

It should be explored whether the use of a modified PFE measure, such as a modified version of the standardised approach to counterparty credit risk (SA-CCR) would be a suitable risk-based alternative. Use of SA-CCR in its current form would be inappropriate as it is not a measure designed to capture contingent funding risk. For example, the 1.4x multiplier is meant to take into account model risk and potentially high correlations of exposures across counterparties – this would be inconsistent with the basic underlying principle of calculating contingent funding risk. Also, the measure does not permit collateral inflows from one counterparty to fund collateral outflows to another. We believe an approach based on SA-CCR would need very careful consideration and further analysis given its potential complexity.

### **Historical Look-Back Approach (HLBA):**

Using the HLBA approach as detailed in the LCR in its current form would not be suitable, as such a measure is a stressed outflow for a one month horizon, defined as the largest absolute collateral flow observed on 30 consecutive days. Moreover, a HLBA should not be based on the largest absolute collateral flow. We would also caution that an inherent flaw in any HLBA approach is that it is backward-looking and restricts the ability of banks to actively manage their funding profiles on a reactive basis.

### **Floor Approach:**

This simple measure would require readjusting the 20% RSF on derivatives liabilities to be applied as a floor. Under the floor approach the total derivatives RSF requirement would be the larger of the 20% of liabilities versus the receivable and IM RSF requirements. The floor would ensure a minimum amount of RSF for derivatives should the base derivatives requirement result in no funding requirement. However, such approach suffers from the same technical deficiencies as does the 20% add-on.

## Recognition of Cash VM

# Recognition of Rehypotheicable Cash VM

Linking the NSFR to the Leverage Ratio cash netting requirements means large portions of cash collateral receive no funding recognition. This will likely result in an additional funding requirement of €130 billion (\$144 billion) across the industry.

## Why the proposed requirement needs to be amended

The NSFR does not recognise a large portion of cash collateral received because recognition is dependent on the Basel III Leverage Ratio (LR) netting criteria. This leads to extreme results that have no grounding in funding or liquidity risk management. This includes:

- The disallowance of collateral as soon as an agreement exhibits a minimal amount of under-collateralisation (where the mark-to-market is not fully extinguished) which introduces significant NSFR volatility that is not related to funding risk.
- The disallowance of collateral received that is not calculated and exchanged on at least a daily basis. This means firms would have to ignore all collateral received from counterparties that post collateral more infrequently; and
- Cash variation margin received that is not in the same currency of the currency of settlement of the derivative contract is disallowed

### LR cash collateral netting criteria vs. funding value of collateral

Criteria	Required for SLR eligibility	Req. for Funding
Not under-collateralized	✓	✗
Cash Only	✓	✗
Enforceable MNA and collateral	✓	✗
Daily Margining	✓	✗
Marg. and settlement ccy the same	✓	✗
Non-segregated	✓	✓
Operational capability to rehyp	✗	✓
Contractual right to rehyp	✗	✓

### Example – Large derivatives portfolio with zero threshold CSA

	T	T+2	DoD variance
Derivative NPV	\$3,000mm	\$3,000mm	-
Cash Collateral	\$2,999mm	\$3,000mm	\$1mm
Actual funding req.	\$(1)mm	-	\$1mm
SLR eligible collateral	-	\$3,000mm	\$3,000mm
<b>NSFR RSF</b>	<b>\$3,000mm</b>	<b>-</b>	<b>\$(3,000)mm</b>

# Recognition of Rehypotheicable Cash VM

## What is the potential impact of the requirement?

- While it may be appropriate to discount collateral that has not been received due to settlement timing or a dispute, ignoring the remaining cash balance received from the same counterparty could lead to extreme results. For example, a one euro collateral shortfall could invalidate €3 billion in cash collateral that a bank would use to fund the receivable.
- This “all or nothing” criteria ignores the real funding value of cash collateral received, and will potentially drive huge day-over-day swings in the derivatives NSFR requirement and increase costs.
- Moreover, ignoring collateral received purely based on the fact that it is posted on a weekly basis as opposed to a daily basis does not make sense from a funding perspective in the context of a ratio designed to ensure stable funding over a one-year time horizon.
- This will likely result in an additional funding requirement of €130 billion (\$144 billion) across the industry (see QIS).

## Industry Recommendations

- The treatment of variation margin should be amended so as to not disallow (i) all collateral when there is partial collateralization; (ii) collateral that is posted and calculated on a more infrequent basis than daily; and (iii) cash collateral received that is not in the same currency of the currency of settlement of the derivative contract.

## Recognition of HQLA VM

# Recognition of Rehypotheicable HQLA VM

The NSFR ignores the funding value of HQLA collateral received. But HQLAs posted provide funding value equivalent to cash. Without recognition, end-users who do not have large cash positions may be forced to use repos to create cash collateral and face novel liquidity risks.

## Why the proposed requirement needs to be amended

- The NSFR limits fundable collateral to cash collateral that is nettable under the Basel III leverage ratio calculation. As a result, the NSFR disregards HQLA collateral received by a bank to reduce its derivative receivables, even when the securities received have cash-like liquidity characteristics (e.g., USTs). This means that US Treasuries, which are treated as cash equivalents for liquidity ratio purposes, are treated as if they were illiquid assets with no funding value.

## What is the potential impact of the requirement?

- This will likely significantly impact end-users, because many end users typically rely on the ability to post securities as collateral. Those end users may need to reduce their derivatives positions or rely on the repo market to transform their assets into cash collateral, and take on substantial new liquidity risk positions. This requirement to enter into additional transactions to achieve the same economic outcome would also further increase the interconnectedness between counterparties.
- According to the industry study, an estimated additional funding requirement of €125 billion (139 billion) will be levied on the entire industry as a result of the lack of recognition of HQLAs. This translates into an additional annual cost of €2.5 billion (\$2.75 billion).

## Industry recommendation

- We believe that the NSFR should give funding credit for rehypotheicable HQLA collateral, particularly Level 1 assets (as per the liquidity coverage ratio), with appropriate haircuts.

## Recognition of Rehypotheicable IM

# Recognition of Rehypotheable Initial Margin

The NSFR ignores the funding value of rehypotheable initial margin (IM) received. This means up to €33 billion (\$36 billion) of an €81 billion (\$90 billion) funding requirement is not able to be offset. We believe rehypotheable IM received can be used to meet IM posting requirements.

## Why the proposed requirement needs to be amended

- IM received by a firm where it has contractual and operational capability to monetise the collateral (i.e. the ability to rehypotheate the collateral) creates funding value for the firm.
- When available for reuse by a bank, initial margin is uniquely well-suited to match funding sources with funding requirements. The bank receives the initial margin at the outset of the derivative transaction, which corresponds with the need to purchase the hedge security, thus matching the start of the funding requirement with the start of the available funding.

## What is the potential impact of the requirement?

- €33 billion of an €81 billion funding requirement is not able to be offset. (see QIS)

## Industry recommendation

- IM received, which is rehypotheable, should be allowed to offset IM posted before the 85% RSF is applied to posted IM.

# Industry QIS

# NSFR Industry QIS (2015)

## Overview

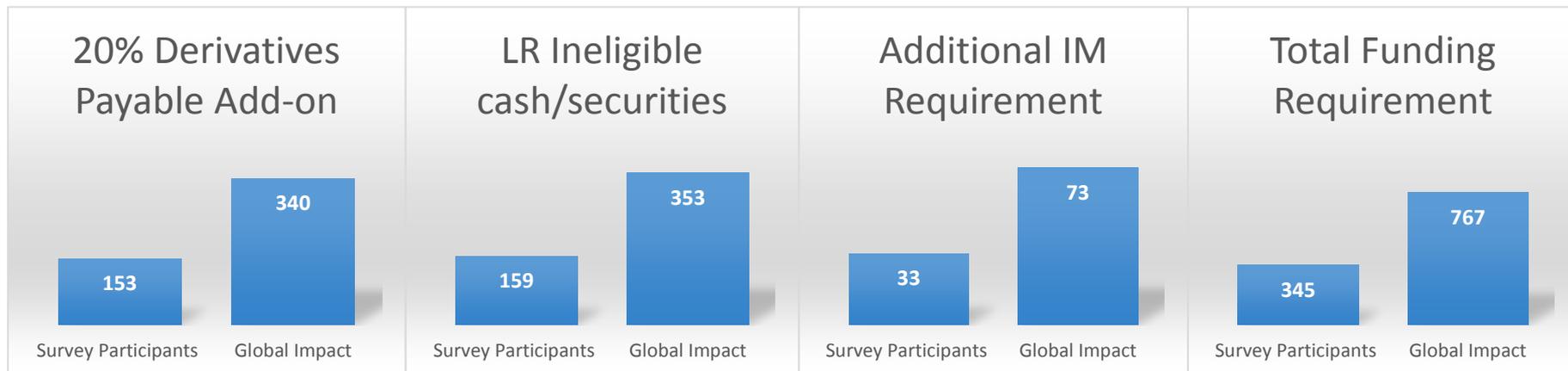
Across the 12 survey participants NSFR results in **€312bn (\$346bn)** additional required long term funding:

- **€159bn (\$176bn)** is due to the fact that the NSFR ignores the funding benefit from cash collateral that is ineligible for Basel III Leverage Ratio netting and the funding benefit from securities collateral; and
- **€153bn (\$170bn)** is due to the 20% derivatives payable add-on.

Additionally, the potential funding benefit of rehypothecable initial margin received, which could offset up to **€33bn (\$36bn)** of this requirement (based on assumption that 70% of IM received can be rehypothecated – this may change under forthcoming WGMR rules)

Therefore, the total derivatives NSFR impact for the 12 survey participants is **€345bn (\$383bn)** additional funding. For the global derivatives market, the total estimated additional funding requirement to be allocated to derivatives businesses is **€767bn (\$851bn)**

The total additional funding cost that will need to be allocated to derivatives business lines will depend on the average cost of long-term debt issued throughout the cycle. At a typical cost of 150bps-200bps the total additional annual cost that would need to be passed along to the end users is **€12 to €15bn (\$13-\$16bn)**.



# NSFR Industry QIS (2015)

## **Methodology**

- 12 bank participants covering approximately 45% of the global derivatives market based on derivatives notionals size.
- 7 European banks, 4 US banks, 1 Asian bank.
- All results are as of December 31, 2014.
- Analysis based on Basel QIS template and US liquidity supplemental template.

## **Participating Banks**

- Bank of America
- BNP Paribas
- Citi
- Commerzbank
- Credit Agricole
- Deutsche Bank
- Goldman Sachs
- JPMorgan Chase
- Nomura
- Nordea
- Societe Generale
- Unicredit