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BY E-MAIL

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Dear Sirs

Consultation Paper on Local Implementation of Basel III Liquidity Rules – Net Stable Funding Ratio (NSFR) and NSFR Disclosure

Introduction

The International Swaps and Derivatives Association, Inc. (“ISDA”) ¹ is grateful for the opportunity to respond to the Consultation Paper on Local Implementation of Basel III Liquidity Rules – Net Stable Funding Ratio (“NSFR”) and NSFR Disclosure published by the Monetary Authority of Singapore (“MAS”) on 16 November, 2016.

ISDA welcomes the concept of a longer term measure of structural liquidity, and strongly supports the underlying policy goals that led to the development of the NSFR by the Basel Committee on Banking Supervision (“BCBS”), including the core objective of requiring banks to develop and maintain sustainable funding structures. We appreciate the work that the MAS is completing in this area, and for the opportunity to respond to the questions posed in the proposed rulemaking. We would note that we are undertaking further quantitative work on the impact of the NSFR on derivatives activities, which we expect to be able to share shortly.

By way of background, ISDA, in concert with other organizations, has expressed to the BCBS very significant continuing reservations on the current BCBS NSFR standard and its impact on capital markets and derivatives activities. We urge the MAS to discuss the analysis it conducted in connection with a final rulemaking with BCBS members with a view to addressing these concerns on a global basis. Whilst the Basel Committee did consult prior to finalising the NSFR, it also introduced a number of new elements in the final standard which it did not consult on, nor – as it acknowledged– did it have sufficient data to analyse. ISDA makes a number of recommendations in this response related to those elements (among other things),

¹ Since 1985, ISDA has worked to make the global over-the-counter (OTC) derivatives markets safer and more efficient. Today, ISDA has over 850 member institutions from 67 countries. These members comprise of a broad range of derivatives market participants, including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure, such as exchanges, intermediaries, clearing houses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association's web site: www.isda.org.
and we believe it is important that the MAS carefully examine several issues of the NSFR as set out in the proposed rule if it does move forward with adoption of a longer term funding measure.

In particular, we respectfully request that the treatment of derivatives under the NSFR needs to be reconsidered. In particular, we believe that two broad elements of the framework would benefit from further consideration: the recognition of margin received by banks and the 20% required stable funding (“RSF”) for derivatives liabilities. Without modification, these two components, according to a quantitative impact study (“QIS”) conducted by the industry\(^2\), will result in:

- An estimated additional funding requirement allocation of €767 billion (SG$1.16 trillion)\(^3\) for the entire industry (extrapolated from a €345 billion (SG$521 billion) requirement across 12 banks\(^4\)) – this is approximately 10 times larger than the total amount of actual funding required;
- A resulting additional annual cost (based on a long term funding cost of between 150-200bps) of between €12-€15 billion (SG$18-$22 billion)\(^5\)

ISDA believes that these key areas should be carefully considered by the MAS in its rulemaking process.

We believe that unless the rules are revised, the current requirements could severely impact the availability and pricing of hedging products for end users, and negatively impact the development of robust capital markets. End users use derivatives to hedge their risks and any rules that could constrain the use of derivatives, may:

- (i) impact companies ability to hedge their funding and currency risks on both newly issued debt and banks loans;
- (ii) hinder infrastructure projects capacity to eliminate mismatches between their revenues and liabilities, thus making such assets less attractive and less safe from an investment perspective;
- (iii) constrict companies ability to hedge their commercial and day-to-day risks resulting in a weakening of their balance sheets, uncertainty in financial performance, and more expensive funding;
- (iv) obstruct cross-border capital flows;
- (v) impede investors looking to hedge the risks inherent in capital markets instruments and their ability to provide sufficient returns to policyholders; and
- (vi) disrupt flows of foreign direct investment.

Finally, we encourage the MAS, as a member of the BCBS, to take the changes that result from the MASs final analysis back to the Basel Committee to obtain the necessary revisions of the Basel NSFR so that a sensible NSFR that is appropriately targeted to its purposes can be implemented consistently on a global basis. Global liquidity standards are very new compared to the global approaches to capital requirements. We believe it is important that they be adjusted where necessary to find methods that are more reflective of the liquidity and funding risks that the international liquidity standards are attempting to address.

A. Recognition of margin received by banks

Under the final BCBS framework, provided certain conditions are met, NSFR derivative assets and liabilities are calculated after counterparty netting and deduction of variation margin. However, the rules introduce an asymmetry between posted and received collateral, which creates an oversized funding requirement not commensurate with the true funding obligations associated with the underlying derivatives portfolios. More

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\(^2\) Industry Analysis of the 2015 QIS on the Net Stable Funding Ratio for Derivatives. The analysis was based on the July 2015 submissions of 12 GSIBS and internationally active banks.

\(^3\) Using a Euro- Singapore Dollar conversion rate of 1.51.

\(^4\) Estimate based on assumption that survey participants represent 45% of total market impact.

\(^5\) An updated version of the study will be submitted to the MAS at a later stage.
generally, the asymmetrical treatment of variation margin received by banks creates unnecessary frictions with regulator-approved variation margin standards, including those expected in Singapore.

As described below, we believe that there are three narrowly tailored accommodations that should be adopted by the MAS to better capture the funding value of margin received by banks:

(i) recognising the full value of all cash variation margin received;
(ii) recognising the full value of all qualifying securities variation margin received, subject to liquidity coverage ratio (“LCR”) high quality liquid asset (“HQLA”) -based haircuts; and
(iii) reflecting the value of re-useable initial margin in the NSFR, where banks are able to use such margin as a funding source for derivatives positions.

i. Recognition of all cash variation margin received

For derivatives liabilities all (posted) collateral must be netted, whereas received collateral related to derivatives assets can only be netted when it is allowable cash collateral. The NSFR does not recognise a large portion of cash collateral received because recognition is dependent on the Basel III Leverage Ratio netting criteria. This is particularly problematic because the leverage ratio netting criteria are exposure-based and do not reflect underlying funding risk.

We are concerned because the linkage to the netting criteria leads to extreme results that have no grounding in funding or liquidity risk management. These include:

- 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\(^6\)) 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\(^7\). 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\(^8\).

We believe that all cash variation margin that has been received is a source of funding for the bank. While it is 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 dollar collateral shortfall could invalidate $3 billion in cash collateral that a bank would use to fund the receivable. This “all or nothing” criteria will potentially drive huge day-over-day swings in the derivatives NSFR requirement and increases 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.

The industry QIS estimates that linkage to the leverage ratio netting criteria will result in an additional funding requirement of €130 billion (SG$196 billion) to be allocated to derivatives portfolios across the industry.

We, therefore, believe that the treatment of variation margin should be amended so as not to disallow all collateral when there is partial collateralisation. We note that the Basel Committee has reopened the leverage ratio rules for consultation\(^9\), in which it has proposed to amend the netting criteria under paragraph

\(^6\) According to Article 25(iv) of the Basel Leverage Ratio Framework, variation margin may only be viewed as a form of pre-settlement payment if a number of conditions are met including: “Variation margin exchanged is the full amount that would be necessary to fully extinguish the mark-to-market exposure of the derivative subject to the threshold and minimum transfer amounts applicable to the counterparty. http://www.bis.org/publ/bcbs270.pdf

\(^7\) Article 25(ii) of the Basel Leverage Ratio Framework

\(^8\) Article 25(iii) of the Basel Leverage Ratio Framework

\(^9\) http://www.bis.org/bcbs/publ/d365.pdf
25(iv) by no longer requiring the exposure be ‘fully’ extinguished. We understand the change is designed to allow for the recognition of variation margin received in situations where the intent is to extinguish the mark-to-market exposure (subject to thresholds and minimum transfer amounts) but a margin dispute arises, where any non-disputed margin that has been exchanged can be recognised. But we also believe that margin exchanged should be recognised in situations where the intent is to extinguish the mark-to-market exposure but operational or settlement issues prevent the full amount being transferred. We, therefore, urge the MAS to amend the NSFR netting criteria to reflect the change to the Basel text.

We also believe that collateral that is posted and calculated on a more infrequent basis than daily should not be disallowed for the purposes of the NSFR.

Furthermore, regarding the requirement that only cash variation margin received that is in the same currency of settlement of the derivative contract is recognised, we support the interim response, as defined in the BCBS October 2014 FAQs, that the currency of settlement means any currency of settlement specified in the derivative contract, governing qualifying master netting agreement (MNA) or the credit support annex (CSA) to the qualifying MNA. However, we understand that the BCBS is currently considering proposing an FX haircut where the currency of the cash variation margin does not match the termination currency of the netting set (i.e. the MNA currency). We believe that no haircut should be applied in cases where the currency of the CVM does not match the termination currency of the MNA. In the event a haircut is employed in the leverage ratio framework, we do not believe it would be appropriate to import such a requirement for the purposes of cash variation netting in the NSFR.

ii. Recognition of rehypothecable high quality liquid assets (HQLAs) received

As noted above, the BCBS NSFR limits variation margin received to cash that meets the BCBS leverage ratio netting standards. In addition to recognising all cash received as eligible to reduce derivatives assets, we also believe that high quality liquid asset securities received as variation margin should also reduce a bank’s derivatives assets. The BCBS NSFR prohibits a bank from reducing its derivative assets with non-cash HQLA variation margin received from a counterparty, even when the securities received have cash-like liquidity characteristics (e.g., US Treasuries). This means that Treasuries, which are treated as cash equivalents for liquidity ratio purposes, are treated as if they were illiquid assets with no funding value.

According to the industry study, an estimated additional funding requirement of €125 billion (SG$189 billion) will be levied on the entire industry as a result of the lack of recognition of HQLAs.

This will likely have a disproportinate negative impact on certain types of end-users – such as mutual funds and pension funds – because many typically rely on the ability to post securities as collateral. Without changes to the NSFR, the added funding requirements (and associated costs) linked with such derivative exposures collateralised with HQLAs could force end users to reduce their derivatives positions, rely on the repo market to transform their assets into cash collateral, and take on substantial new liquidity risk positions, or divest their assets for cash (to the detriment of fund performance).

Therefore, we believe that the NSFR should give funding credit for rehypothecable HQLA collateral, particularly Level 1 assets (as per the LCR), with appropriate haircuts.

iii. Recognition of rehypothecable initial margin received

Apart from variation margin netting, the BCBS NSFR also fails to consider the funding value of initial margin received by banks. The BCBS NSFR assigns no ASF value to rehypothecable initial margin received from counterparties, even when such initial margin can be used as an actual funding source by a bank under applicable regulations.

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10 This was recognised by the MAS in its proposed rulemaking on margin for non-cleared derivatives, which allows the use of non-cash forms of collateral for variation margin.
We agree, in principle, that when considered in isolation initial margin is not a stable funding source for a bank’s entire balance sheet; however, the relevant question is whether it is an appropriately matched funding source for assets held by the bank as derivatives hedges that are, in reality, actually funded by the initial margin, and which will be sold by the bank when the derivative position closes out.

One weakness of the BCBS NSFR is that it assumes that all assets require long-term funding, whereas in reality the funding requirements for a particular asset depend on the purpose for which the bank holds the asset. Clearly, assets held by the bank for long-term investment require long-dated funding support; similarly, market-making positions in less liquid securities also present funding risk. When securities are held as market risk on derivatives hedges, however, the funding requirements of such assets depend on the underlying derivative. Derivatives hedges supporting a one-month swap require one month of stable funding, as they will be liquidated at the termination of the swap; hedges supporting a one-year swap require one year of funding.

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.

B. The 20% RSF add-on for derivatives liabilities

The industry is particularly concerned by the 20% RSF that applies to derivatives liabilities before the netting of posted collateral or derivatives assets. 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. ISDA is uncertain how the BCBS developed this methodology and whether its impact is fully understood.

We now understand the measure – which will result in an additional industry-wide funding requirement of €340 billion (SG$513 billion) to be allocated to derivatives portfolios\(^\text{11}\) and potentially have a negative effect on markets and end users – is designed to capture contingent liquidity risks.

However, we believe that such contingent funding risks related to derivatives MTM movements are already adequately 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 either:

(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.

Moreover, the derivatives industry is continuing to evolve and refine its approaches to managing contingent pledging risk from derivatives. At this time, however, there are no widely accepted methodologies or approaches to quantifying this sensitivity and banks employ a variety or in-house developed models to establish buffers against this risk.

It is also worth noting that both derivatives assets and liabilities tend to balloon in stressed conditions, and as such, although a firm’s net funding requirement might not change, the use of a gross add on would require extra funding be raised – a pro-cyclical requirement.

\(^{11}\) As per the Industry QIS.
Therefore, the industry believes the current 20% of gross derivatives liabilities cannot be reasonably evaluated or trading actions adapted without further understanding of the basis and intent of the RSF factor. 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.

We, therefore, believe it would be more sensible to explore the possibility of adopting a measure that is more sensitive to future funding risk.

However, given the tight timeline to respond to the consultation we have been unable in the time given to sufficiently consider and perform a thorough analysis of the potential impact of different alternative methodologies. We, therefore, will continue to consider alternatives to the 20% RSF over the coming months and commit to provide the MAS with commentary and analysis on suitable alternatives that we will also share with the BCBS and regulators outside of Singapore to ensure global harmonization.

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 MAS defer the adoption of a measure until they has been able to fully assess and observe the potential impacts of different alternatives. To this end we believe that the MAS should re-propose this aspect of the proposed ruleset.

We believe the MAS should consider in their analysis methodologies including, but not limited to, the below. However, we reiterate that the industry has not had sufficient time to explore the suitability of the below methodologies, and we aim provide additional considerations and analysis as to their appropriateness over the coming months.

- **Use of the standardised approach to counterparty credit risk (SA-CCR):** Using SA-CCR in either of its current forms (for risk-based capital, or as modified for leverage), would not be appropriate, as it is a measure of Potential Future Exposure (PFE) used for credit risk purposes, and not a measure of contingent funding risk. ISDA is willing to explore further whether a modified version would be suitable. Further analysis is required and should thoroughly assess whether the different elements of the SA-CCR framework are appropriate for calculating future 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.

- **Use of a historic 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.

- **20% Floor:** 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.
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.

C. Derivatives transactions with central banks arising from short-term monetary policy and liquidity operations

Under the BCBS NFSR FAQs (July 2016), FAQ 33 clarifies the scope of derivative transactions arising from central banks’ short-term monetary policy and liquidity operations, which the MAS has also adopted. The industry supports this exemption, however would welcome clarification from the MAS that the application not limited to only FX instruments, but applies to all derivatives (regardless of asset class) that meet the criteria.

We also believe that the guideline should be amended so that contracts that have a “residual maturity” of less than 6 months, rather than a six month maturity “at inception”, will qualify for the waiver. This would be consistent with the interpretation adopted in other jurisdictions.

We thank the MAS for considering our comments and the comments of other industry stakeholders in this process. We look forward to continued dialogue on these issues going forward. Should you have any questions, please do not hesitate to contact me (mgheerbrant@isda.org), Keith Noyes (knoyes@isda.org), Matt Cameron (mcameron@isda.org) and Rahul Advani (radvani@isda.org).

Yours sincerely,

For the International Swaps and Derivatives Association, Inc.

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