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Dear Mr. Brennan

DRAFT ONLY

Basel III liquidity – the net stable funding ratio and the liquid assets requirement for foreign ADIs

The Australian Financial Markets Association and International Swaps and Derivatives Association welcome the opportunity to comment on the Basel III liquidity framework discussion paper. The following comments are based on consultations with AFMA's Foreign ADI Working Group and ISDA's Risk & Capital Group.

In relation to the scope of application for the net stable funding ratio (NSFR), the Associations understand that the NSFR will only apply on a consolidated basis to internationally-active banks as identified in the discussion paper. Foreign bank branches in Australia will not be subject to domestic NSFR arrangements.

The discussion paper canvasses two options in relation to the liquid assets requirement for foreign ADIs.

I. Option 1 is the proposed foreign ADI liquid assets requirement (FALAR), under which foreign bank branches would hold specified liquid assets equal to at least nine percent of external liabilities, including related-party entities.

II. Option 2 is to make permanent the existing interim arrangements involving a 40% LCR.

The Associations support the intention behind Option 1, which is to put in place a simplified regime that would improve on the current interim regime. However, consultations with the Associations' members indicate that further information is required in order to form a view as to which of these two options is preferable on balance. In particular, more information on the definition of external liabilities is required to quantify the costs and benefits of the FALAR option. There is support among

some members for a hybrid or dual regime, which is perhaps indicative of the lack of certainty around the implications of Option 1.

Consistency with global liquidity frameworks

Some members have noted that Option 2 has the advantage of maintaining a domestic liquidity framework for foreign ADIs that is consistent globally except in terms of the percentage of the liquidity coverage ratio and the definition of HQLA. The larger foreign ADI's in Australia are familiar with this regime as foreign branches are already operating under a similar global standard. This is despite the volatility associated with the LCR.

Option 1 effectively creates two liquidity regimes for domestic and foreign ADIs. The creation of a second regime for foreign ADIs may in some cases require additional explanation to head office and may be more demanding operationally for the purposes of implementation given that local systems are built around the implementation of the global standard. As noted on page 20 of the discussion paper, Option 1 may create problems when calculating LCR on a global basis as well as result in some duplication of effort.

Definition of external liabilities

Further clarity needs to be given to the definition of external liabilities under Option 1. In particular, APRA seem to have adopted a jurisdiction-based definition of external liabilities, rather than an institutional or entity-based definition. An entity-based definition would be a better reflection of the true liquidity position of foreign ADIs.

The Associations propose the following treatment for external liabilities.

Derivatives should be netted and included as an external liability only to the extent that a foreign ADI is in a net payable position. In the absence of netting, the size of the external liability will be over-stated.

The definition of external liabilities should exclude liability deposits with head office and other branches. These deposits are a substantial source of liquidity for some foreign ADIs and are not appropriately viewed as external given they are provided by the same legal entity.

The definition of external liabilities should include liability deposits with related legal entities that are external to the branch regardless of jurisdiction.

Committed facilities should be included in the definition of external liabilities, while uncommitted facilities should be excluded. Committed facilities create binding obligations that can result in an outflow and deterioration in a foreign ADI's liquidity position. Uncommitted facilities, by contrast, are at the discretion of the ADI.

The calculation of FALAR should be in AUD terms, with AUD assets held exclusively against 9% of AUD external liabilities, without aggregation of foreign currency liabilities. Because some foreign ADI's have significant foreign currency liabilities, holding AUD assets against these liabilities generates additional currency risk. An AUD-only calculation will be simpler to implement and comply with.

Repurchase obligations should be excluded from external liabilities because assets in the form of securities received are already held against the external repo liability.

Reporting against the FALAR should be consistent with the current reporting arrangements under LCR.

Other considerations

Members are also seeking clarity around the local operational capacity (LOC) assessment and whether this is limited to ensuring the ability to make payments and receipts or whether a broader LOC is envisaged, as suggested by the reference to the ability to "perform other vital functions" on page 21 of the discussion paper.

Treatment of derivatives exposures under the NSFR

We believe that the treatment of derivatives under the NSFR needs to be reconsidered. In particular, both the recognition of margin received by banks and the 20% required stable funding (RSF) for derivatives liabilities require further consideration. Without modification, these two components, according to a quantitative impact study (QIS) conducted by the industry, will result in:

- An estimated additional funding requirement of €767 billion for the entire industry (extrapolated from a €345 billion requirement across 12 banks) – this is approximately 10 times larger than the total amount of actual funding required;
- This translates into an additional annual cost (based on a long term funding cost of between 150-200bps) of between €12-€15 billion.

1. Recognition of margin received by banks

Under the final Basel 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.

i. Recognition of 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 recognize a large portion of cash collateral received because recognition is dependent on the Basel III Leverage Ratio (LR) netting criteria. LR netting criteria disallows collateral as soon as an agreement exhibits a minimal amount of under-collateralization (where the mark-to-market is not fully extinguished) which introduces significant NSFR volatility that is not related to funding risk.

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 dollar collateral shortfall could invalidate A$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 increases costs.

The industry QIS estimates that this will result in an additional funding requirement of €130 billion across the industry.

We believe that the treatment of variation margin should be amended so as not to disallow all collateral when there is partial collateralization. We note that the Basel Committee has reopened the Leverage Ratio rules for consultation[1], in which it has proposed to amend the netting criteria under paragraph 25(iv) by no longer requiring the exposure be 'fully' extinguished.

ii. Recognition of rehypothecable high quality liquid assets received

Because the NSFR also limits fundable collateral received to cash collateral nettable under the Leverage Ratio criteria, as a result, HQLA collateral received by a bank to reduce its derivative receivables is disregarded, 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.

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

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

2. The 20% RSF for derivative liabilities

In addition to margin recognition issues, a further 20% RSF applies for derivatives liabilities before the netting of posted collateral. The 20% liability formula was not included in any NSFR consultative document and hence industry did not have an opportunity to comment on it. The Associations are uncertain how the Basel Committee developed this methodology and whether its impact is understood.

While we understand the measure is designed to capture contingent liquidity risks, such risks related to derivatives MTM movements are already in part captured by the LCR and are realised through collateral outflows. The size of a gross payable on a bank's balance sheet is not a good indicator of a firm's market contingent funding requirements as it does not take into account either: (1) the collateral a firm is required to post to secure its derivative liabilities or (2) the rehypothecable cash and liquid securities collateral a firm receives from other counterparties to secure its derivative assets. The additional industry-wide funding requirement associated with the 20% RSF is €340 billion according to the industry QIS.

Thus, we believe that a more risk-sensitive measure should be used to capture potential long-term future funding needs.

[1] http://www.bis.org/bcbs/publ/d365.pdf

Conclusion

The Associations recommend that APRA consult further on the definition of external liabilities under the FALAR option and provide further clarity on the issues highlighted above before issuing a draft revised APS 210.

Given that implementation is not scheduled until 2018, the Associations see little cost to extending the consultation period beyond 31 May. In the absence of more clarity around these definitions, it is difficult for foreign ADIs to take a preferred view in relation to the two options based on information provided by APRA to date.

The Associations are happy to facilitate further consultation in relation to these options.

Yours sincerely

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Economist
Australian Financial Markets Association

Keith Noyes
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ISDA

Appendix 1 – Derivatives Industry QIS (*Source: ISDA)*

Net Stable Funding Ratio
Derivatives – Industry Quantitative Impact Study

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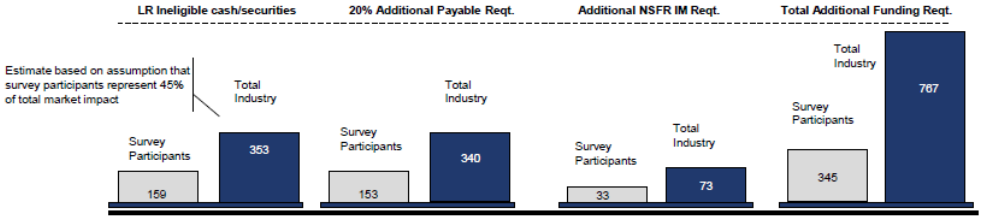
Overview

- 12 bank participants covering approximately 45% of 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 U.S. liquidity supplemental template

Highlights

- For the average survey participant the NSFR long term funding requirement from derivatives assets, liabilities and variation margin is approximately 10 times larger than the total amount of actual funding required
  - Across the 12 survey participants NSFR results in €312bn additional required long term funding
  - €159bn or approximately half of the increase is due to the fact that NSFR ignores the funding benefit from cash collateral that is ineligible for Basel III Leverage Ratio netting and the funding benefit from HQLA securities collateral
  - €153bn is due to the 20% derivatives payable add-on
- Additionally, for the survey participants the NSFR requires €81bn of long-term funding for initial margin, but ignores the potential funding benefit of rehyp initial margin received, which could offset up to €33bn of this requirement[1]
- The total derivatives NSFR impact for the 12 survey participants is € 345bn additional funding. For the entire industry the total estimated additional funding requirement is €767bn
- Banks need to raise long-term unsecured funding to meet this additional requirement. The total funding cost will depend on the average cost of long-term debt issued throughout the cycle. At a typical cost of 150bps-200bps the total annual cost that would need to be passed along to the end users is € 12 to € 15bn



1 Based on estimate that on average 70% of initial margin received by banks can be rehypothecated

1

Net Stable Funding Ratio
Derivatives – Industry Quantitative Impact Study
Assets, Liabilities and Variation Margin (EUR billions)

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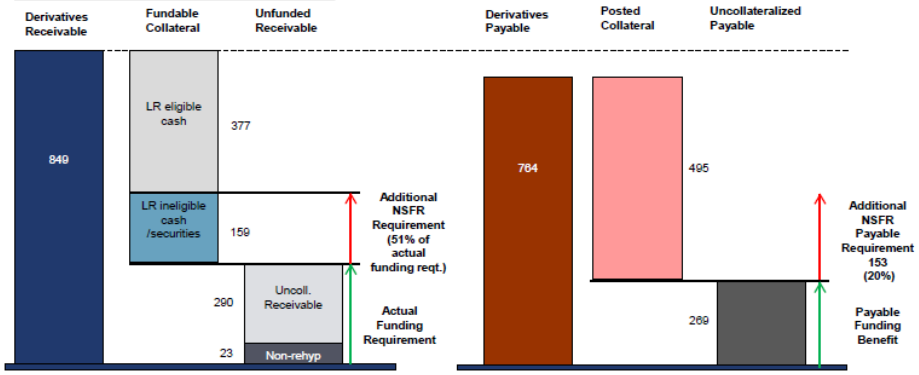
- For the 12 survey participants, NSFR ineligible cash and HQLA collateral and the 20% add-on result in an incremental funding requirement of €312bn
  - Disallowing cash collateral that is ineligible for Basel III Leverage Ratio netting and disallowing HQLA securities collateral results in an incremental requirement of €159bn
  - The 20% payable add-on results in an incremental funding requirement of €153bn
- The total spot funding requirement consists of the uncollateralized receivable and non-rehyp collateral net of the uncollateralized payable; for the typical bank this was only ~10% of the total NSFR RSF requirement

NSFR funding profile of participant banks



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Net Stable Funding ratio

Derivatives – Overview of Basel III Treatment

Initial Margin (EUR billions)

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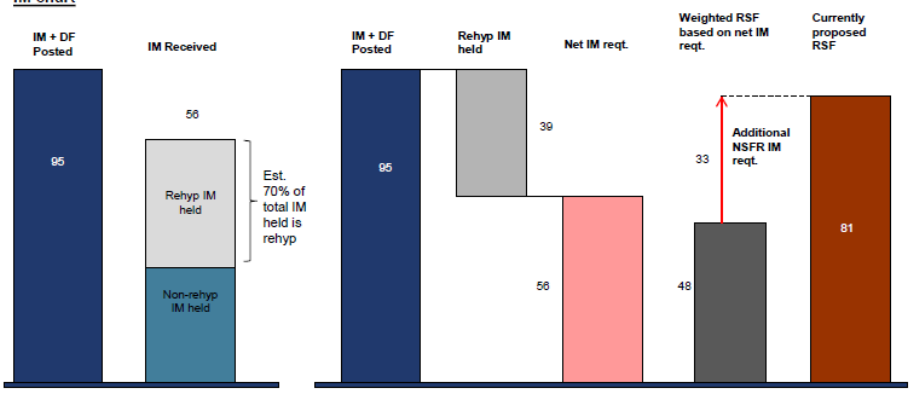
- For the 12 survey participants, the total NSFR long term funding from Initial Margin (IM) requirement including Default Fund (DF) is €81bn
  - NSFR ignores €33bn of potential funding benefit of rehyp initial margin received

IM chart



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Net Stable Funding Ratio

Derivatives – Industry Quantitative Impact Study

List of participants

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

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