NSFR – the 5% Derivatives Liability Add-On

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ISDA, GFMA, and IIF (the Associations)[1] welcome the decision by the Basel Committee on Banking Supervision (BCBS) in its review of the Net Stable Funding Ratio (NSFR) to give national jurisdictions the ability to lower the punitive 20% add-on for gross derivatives liabilities (GDL), to 5%.

We believe that the BCBS should adopt the 5% as a permanent measure, as this would reflect an appropriate compromise that would promote international consistency and avoid unintended consequences to derivatives businesses. To the extent that the BCBS chooses to take no further action and jurisdictions move ahead with implementation of the NSFR, we believe that they should do the same. Doing so would also:

- free up resources within both the public and private sectors to focus on other critically important issues;
- ensure international consistency in the application of a framework and a level playing field for firms across jurisdictions; and
- avoid a potential increase systemic risk resulting from market fragmentation that would occur if different jurisdictions were subjected to different requirements.

The Associations have long supported the underlying policy goals of the NSFR, requiring banks to develop and maintain sustainable funding structures. However, we believe that a 20% add-on would have potentially negative consequences on capital markets, including severely restricting banks' ability to provide market services which facilitate client financing, investing and hedging. While the 20% add-on was not tested in advance of the final BCBS rule, the industry has since had an opportunity to assess the impact and has determined that the 20% add-on grossly overstates future funding risk and does not incentivise managing derivatives funding volatility. If a jurisdiction does not lower the GDL add-on to 5% in its NSFR implementation, this measure will likely lead to fragmentation in derivatives markets and increase volatility and systemic risk.

No consensus on credible alternatives

For the past three years, both industry and policymakers have sought to develop alternative measures to the 20% GDL add-on. However, given the complexity of the policy objective, both industry and policymakers have yet to find a measure that is both simple to implement, appropriately risk sensitive and calibrated to the appropriate level of risk the add-on is trying to measure. We understand the desire by some within the BCBS to continue to search for a credible alternative, and stand ready to continue to provide technical support.

Therefore, we believe that in order to capture contingent funding risk and the desire to preserve simplicity in the NSFR framework, a 5% GDL add-on would be an appropriate compromise that, if applied consistently across jurisdictions, would result in limited impacts on derivatives businesses. We estimate that the industry as a whole would still be required to raise €85 billion in

[1] See Annex for descriptions of the Associations and contact details.

additional stable funding, but believe this is less punitive than the €340 billion which would have been otherwise required under the original proposal.

Addressing level playing field concerns

If the BCBS does not choose to adopt a single international standard at 5%, and if a jurisdiction chooses to implement a higher standard than the 5% floor while others adopt a lower requirement, firms in that locality will be placed at a competitive disadvantage relative to their peers. Banks will be forced to price these additional funding costs into client trading activities, potentially making them uneconomic. This is an undesirable, and entirely avoidable, outcome. Derivatives markets are global, and for a market to continue to be an attractive place for investment, a level playing field is paramount across jurisdictions. If a jurisdiction chose to implement an add-on higher than 5%, it runs the risk that large customers who are operationally able to, will simply choose to take their business elsewhere given the increased costs. At the same time, smaller end-users may choose to stop using derivatives to hedge their risks entirely, potentially leading to more volatility and systemic risk.

Avoiding risk concentration

We also believe that inconsistency in application of the add-on will lead to market fragmentation, regional liquidity pools and risk concentration. This is clearly something that policymakers desire to avoid, and yet it is a likely outcome in any market where authorities choose implement an add-on higher than 5%. We expect that other jurisdictions around the globe, including those with large derivatives markets, will adopt the 5% add-on, and markets with higher add-ons, and global stability, will suffer as a result.

Conclusion

For these reasons, we believe the decision to adopt a 5% GDL add-on should be a permanent one. For any jurisdiction that adopts a rule where the add-on measure reverts to the BCBS standard after a specified period, firms there will face severe uncertainty and risk “cliff-edge” effects if the BCBS does not change its standard in the intervening time. This type of uncertainty and risk prevents firms from being able to conduct appropriate business planning, and may result in banks limiting their derivatives businesses in order to avoid cliff-edge cost increases.

We believe national policymakers should adopt the 5% as a permanent measure, and also press the BCBS to do the same in order to prevent uncertainty, avoid global fragmentation and contribute to robust and efficient derivatives markets. We recognize that they have left open the possibility of a future consultation to explore an appropriate risk sensitive alternative, and should they choose to do so, the Associations will stand ready to once again work with policymakers to advance this objective. However, given that at this time they have not chosen to do so, and with many jurisdictions set to implement NSFR rules in the near future have left the discretion to national authorities to make this determination, we believe that it is equally critical that if national policymakers proceed with implementation, they include a permanent 5% GDL add-on. Finally, the Associations continue to believe that policymakers should reconsider the NSFR’s treatment of cash and HQLA variation margin, as the standard does not reflect best risk management practices and severely restricts the types of collateral clients may post. We again encourage the BCBS to review these aspects of the NSFR.

Annex – Descriptions of the Associations and Contact Details

DESCRIPTIONS OF THE ASSOCIATIONS

International Swaps and Derivatives Association: Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has more than 875 member institutions from 68 countries. These members comprise 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

Global Financial Markets Association: The Global Financial Markets Association (GFMA) brings together three of the world's leading financial trade associations to address the increasingly important global regulatory agenda and to promote coordinated advocacy efforts. The Association for Financial Markets in Europe (AFME) in London, Brussels and Frankfurt, the Asia Securities Industry & Financial Markets Association (ASIFMA) in Hong Kong and the Securities Industry and Financial Markets Association (SIFMA) in New York and Washington are, respectively, the European, Asian and North American members of GFMA. For more information, visit http://www.gfma.org.

Institute of International Finance: The Institute of International Finance is the global association of the financial industry, with close to 500 members from 70 countries. Its mission is to support the financial industry in the prudent management of risks; to develop sound industry practices; and to advocate for regulatory, financial and economic policies that are in the broad interests of its members and foster global financial stability and sustainable economic growth. IIF members include commercial and investment banks, asset managers, insurance companies, sovereign wealth funds, hedge funds, central banks and development banks.

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