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European System of Financial Supervision

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ESRB response to the consultation on the Net Stable Funding Ratio (NSFR) as mandated by Article 510 CRR

Dear Mr. Enria,

According to Article 510 of the CRR, the ESRB shall be consulted by the EBA on the methodologies for determining the amount of stable funding available to and requested by institutions, and on appropriate uniform definitions for calculating such a net stable funding requirement. This letter summarizes the views of the ESRB Advisory Technical Committee on this important topic.

Before proceeding further, please allow me to quickly review the macro-prudential role allocated to the NSFR in the CRD/CRR framework. Indeed, from a legal perspective, liquidity instruments are included amongst the macro-prudential instruments in Article 458 CRR as well as in Articles 103 and 104 of the CRD, which cover Pillar II measures. In particular, according to Article 458 CRR, national competent authorities may, following the due process described there, temporarily increase the liquidity requirement if they are concerned about the systemic risk developments in their jurisdictions.

Overall considerations

The macro-prudential use of liquidity instruments has been discussed in several occasions at the ESRB. The ESRB Handbook on Operationalising Macro-prudential policy in the banking sector, published in 2014[1], discusses the potential use of the net stable funding ratio (NSFR) as a macro-prudential instrument. Similarly, the ESRB response to the call for advice by the European Commission on macro-prudential

[1] See http://www.esrb.europa.eu/pub/pdf/other/140303_esrb_handbook_mp.en.pdf.

rules in the CRD/CRR[2] refers, amongst others, to the potential use of the NSFR for macro-prudential purpose, although draws a word of caution to the need to better understand how the NSFR works before embarking in a macro-prudential requirement as such. Furthermore, the report by the ESRB on indirect contagion identifies the macro-prudential use of liquidity regulation, including requirements which can vary both over time and in the cross-section of regulated institutions, as a potentially effective policy innovation.

Based on the previous work within the ESRB, there is the broad view that the macro-prudential application of the NSFR could take place with two dimensions: (i) a time-varying requirement, potentially composed of a minimum requirement and the possibility to complement it with a macro-prudential buffer, which could be released in times of stress for institutions[3]; and (ii) a cross-sectional requirement, calibrated according to each institution contribution to systemic liquidity risk (similarly to the way the Systemic Risk Buffer works for capital requirements).

The two dimensions above would impose a remarkable challenge on macro-prudential authorities, in what regards the calibration of the NSFR. Nonetheless, on the other hand, complexity cannot deter macro-prudential authorities from acting and not making use of the macro-prudential dimension of the NSFR, as this would exclude a decisive macro-prudential instrument from the toolkit of macro-prudential authorities when addressing systemic liquidity risk.

The ESRB understands that the European Commission will need to make necessary amendments to Article 458 CRR, in view of the inclusion of the NSFR among the instruments subject to national flexibility for macro-prudential reasons. Accordingly, the ESRB would like that the EBA report recommends having an explicit mention to the NSFR as one of the various macro-prudential tools referred to in Article 458 CRR. Similarly, amendments to Articles 103 and 104 CRD may be necessary to reflect the introduction of a NSFR requirement.

The ESRB Handbook on Operationalising Macro-prudential policy in the banking sector recognises that the use of instruments to address systemic liquidity risk is an area

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[2] See https://www.esrb.europa.eu/pub/pdf/other/140430_ESRB_response.pdf.

[3] It has been empirically observed during recent times of stress that outflows incur both in stable and in less stable funding sources, resulting in a material change in a bank's funding mix. In particular, customer deposits (long term stable funding with ASF factor = 90% - 95%) might be substituted by short term funding in the context of lender of last resort (ASF factor = 0% - 50%), driving down a bank's NSFR. Temporary liquidity jitters could impose contagion effects in the banking system and trigger a systemic crisis. Thus, the adaptable time-varying requirement could have important benefits for both micro- and macro-prudential supervisors.

at an early stage of development, with relatively little experience to draw on. On this basis, some members of the ESRB have made the following considerations:

- With regard to a time-varying requirement, the possibility to release the NSFR requirement can have important benefits for micro- and macro-prudential supervisors. As experience with the macro-prudential use of the NSFR is still limited, a flexible use should not be pre-empted.
- In terms of implementation, given the limited experience with the impact and effects with the new liquidity standards, the micro-prudential NSFR standard would be finalised first, then its net effects both on bank-specific and systemic liquidity risks would be assessed, while continue developing the understanding of macro-prudential liquidity instruments, before drawing final conclusions for the macro-prudential use of the NSFR[4].
- Departing from a globally-agreed methodology could have undesired and unknown effects for the EU banking system, in terms of level playing field, incentives and systemic liquidity risk.

For these reasons, further work should be encouraged in the calibration of the NSFR requirement for macro-prudential purposes, including an economic analysis through the economic cycle as well as a quantitative analysis on the costs and benefits.

Response to the specific areas in Article 510 of the CRR

Article 510 of the CRR specifies four areas where the ESRB shall be consulted. In this vein, the ESRB Advisory Technical Committee would like to make the following comments.

Concerning the categories and weightings to the sources of stable funding and to the requirement for stable funding in the minimum requirement, it is of the essence that the guidance set by the Basel Committee on Banking Supervision (BCBS)[5] is followed. Otherwise, departing from a globally-agreed methodology would have undesired and unknown effects for the EU banking system, in terms of incentives and systemic liquidity risk. Therefore, the ESRB welcomes the fact that the weights proposed by the EBA for the different assets and liabilities mirror those by the BCBS,

[4] In this sense, some ESRB members believe that measuring systemic liquidity risks and the extent to which they are addressed by existing standards and instruments are promising avenues for future work.
[5] See http://www.bis.org/bcbs/publ/d295.pdf.

except for the limited cases where the BCBS text basically advocates for national discretion (mainly, interdependent assets and liabilities[6]).

The ESRB report on indirect contagion mentions as a possible macro-prudential tool in the area of liquidity the variation of the weights assigned to assets and liabilities in the computation of the NSFR. Such an approach would work analogously as the framework defined by Articles 124 and 164 of the CRR, according to which risk weights of exposures to real estate can be raised due to financial stability considerations. Such a tool would mean that weights to assets and liabilities could be used pro-actively when financial stability concerns are mounting, implying that there would be different weights applied to the same assets and liabilities by banks in different jurisdictions. This is certainly a newly-proposed and promising area of work, which may be worth exploring in detail in the long-term.

The opinion of the ESRB is sought as well on the incentives and disincentives for the stable funding of assets, business activities, investments and funding of institutions. In relation to this, the NSFR has been widely identified as the best available instrument to address structural liquidity and maturity transformation by banks[7]. This importance calls for a very precise calibration of the ratio, in order to give the adequate incentives to banks, with the overarching objective of maintaining a desired balance between the liquidity and maturity of their assets and liabilities. At the same time, existing business models shall be considered and not unintendedly dis-incentivised when it has been proven that they do not pose systemic liquidity risk. In this domain, the ESRB would like to make the following comments:

i. It has been argued that one of the main unintended consequences of the implementation of the NSFR is that it may lead to investments in similar and/or correlated portfolios (those requiring less stable funding). In other words, the NSFR requirement may hamper diversification, both within institutions and across the banking sector at large. This argument is partially true but fails to grasp the essence of the NSFR requirement, which is not directing the composition of the portfolio of institutions, but rather aiming at limiting the maturity and liquidity mismatch between assets and liabilities (i.e., funding

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[6] It is important that the accommodation of EU specificities where the BCBS establishes national discretion does not distort what is intended by the BCBS text. For example, in the area of interdependent assets and liabilities, derivative transactions would be excluded from the scope for national discretion.

[7] See, among others, The Net Stable Funding Ratio: Impact and Issues for Consideration by J. Gobat, M. Yanase, and J. Maloney, IMF Working Paper 14/106.

long-term assets with short-term market liabilities, which embodies a significant roll-over risk).

ii. It is often claimed that the current BCBS methodology seems to favour traditional banking models (based on loans and deposits) against market-based banking activities. It shall be reminded, again, that the behaviour the NSFR requirement is seeking to prevent is that where short-term market liabilities are used to finance long-term assets. The use of short-term market liabilities to finance short-term assets is not penalised by the NSFR requirement, except when dealing with short term loans to financials where an asymmetric treatment between assets and liabilities has been introduced by the BCBS[8].

iii. The EBA report finds no correlation between the NSFR variation and the change in trading book assets in 2014 (which is the only year of data availability in the analysis), and signals limited concerns about the different impact of the NSFR requirements across business models, as shortfalls are found in all business models and usually limited to a reduced number of institutions. While the costs to comply with the NSFR requirement for those institutions with a shortfall is one of the several factors to be considered when considering the practical implementation of the NSFR requirement, the ultimate goal of EU authorities should be the implementation of a credible and sound NSFR requirement in the EU.

Finally, views of the ESRB are sought on the convenience to develop different methodologies for different types of institutions. Here, the ESRB would like to note that the methodology developed by the BCBS only applies to internationally active banks on a consolidated basis. On the contrary, the EBA is proposing that the NSFR in the EU covers all the registered banks in the EU[9], going thus beyond the minimum scope set forth by the BCBS standard. That would call, in principle, for a simplified regime for smaller institutions.

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[8] This provision aims at recognizing the existence of funding risk in these transactions since at least some stable funding for a minimum roll over rate of the underlying loans must be ensured. The impact of this provision on specialised business models, including market-based banking activities, is certainly not negligible.

[9] This is also in line with the decision on the other quantitative liquidity requirement introduced by the Basel Committee, the Liquidity Coverage Ratio, which according to the Delegated Regulation of the Commission (EU) n. 2015/61 applies to all EU banks.

A majority of members of the ESRB Advisory Technical Committee are of the view that the desired application of the proportionality principle is not to be applied to the methodology for the computation of the ratio, but rather, to the supervisory reporting of the NSFR. The liquidity and maturity mismatches which the NSFR aims at addressing are also relevant for smaller institutions. In this regard, hence, the same methodology must be defined for smaller and larger institutions, as proposed in the EBA report. As said, an area where smaller institutions can be alleviated is that of supervisory reporting, where they may be, for example, subject to less detailed reporting requirements (although maintaining the quarterly frequency).

Two members of the ESRB would like to explore ways to tailor the NSFR requirement to different sizes of banks and/or different business models (i.e., small banks with particularly simple and traditional funding sources). In their view, a "one-size-fits-all" NSFR requirement may not be the most appropriate response to the risks it aims at mitigating[10].

Other comments

There are two further issues on the definition of the methodology for the NSFR which merit attention from a macro-prudential point of view. They are (i) the consideration of setting a NSFR requirement by currency, and (ii) the extension of the requirement beyond the consolidated level.

On the latter, the BCBS methodology explicitly mentions that its scope is limited to the consolidated groups, not considering the application of the methodology at the level of individual institutions within a group. The EBA report discusses these two alternatives and proposes an application of the NSFR also on an individual basis, subject to waivers or exemptions. In this area, the ESRB would like to note the following:

- Management of liquidity within large and complex banking groups is often undertaken in a separate (or a group of separate) entity (entities) of the group. Imposing a NSFR requirement to individual institutions may not take fully into consideration how liquidity is managed at the consolidated level.

[10] The ESRB Handbook on Operationalising Macro-prudential policy in the banking sector notes that the NSFR is meant to address externalities due to interconnectedness and expectations of public support and not all banks are equally interconnected or have the same potential adverse impact on the economy.

- Imposing a NSFR requirement at consolidated level only could create difficulties in the case of large banking groups which are present in several countries and where each supervisor is able to react only to developments in liquidity risk in the institutions under its jurisdiction. On the other hand, imposing a requirement on a solo basis could hamper the free movements of funds within the EU, but may be justified from a prudential perspective given the incompleteness of the banking union

In the view of the above two points and in agreement with the proposal by the EBA, the ESRB would prefer to have the NSFR requirement also extended to the individual institutions, even if it implies an extension of the minimum scope of the requirement by the BCBS. To alleviate the potential higher burden imposed by such requirement, there are several actions which could be considered:

i. Preferential and symmetrical weights could be given to intragroup assets and liabilities under strict conditions (this should only apply if liquidity is managed jointly and institutions are jointly liable). Embarking into a process of determining weights for intragroup assets and liabilities, and whether they should be higher or lower than those for similar transactions with third parties, is certainly a daunting task which deserves careful discussion of pros and cons.

ii. A system of waivers from the application of the requirement at individual level could be envisaged, provided that appropriate conditions are met. Smaller subsidiaries[11] could be exempted from the requirement provided that it applies to a parent situated in the same country. In case of cross-border groups, the exemption of the subsidiaries should be carefully considered and allowed only under strict conditions (e.g., joint liability), in order (i) to ensure stable funding of those subsidiaries, and (ii) not to set obstacles to the free movement of funds across the Union. This waiver would be in line to that currently proposed by the EBA in its report, related to Articles 8 and 10 of the CRR.

Second, the current supervisory reporting framework for the NSFR defined by Articles 415, 427 and 428 of the CRR, which are expected to be the basis for the calibration of

[11] Smaller subsidiaries should be identified by looking at their importance in the host country, not within the respective banking group. It may happen that some subsidiaries that are not very significant for the whole group (e.g. in terms of assets or profits) are still very important in the host country.

the NSFR requirement, considers significant currencies[12] separately. Besides, the other major liquidity instrument, the Liquidity Coverage Ratio (LCR), explicitly requires to be monitored by reporting currency and by significant currencies[13]. A specific LCR requirement by significant currency can be imposed by the supervisor as a Pillar 2 measure. On the other hand, while the BCBS methodology for the NSFR requirement does not explicitly refer to significant currencies, the standard for the LCR calls for monitoring the LCR per significant currencies[14].

When considering the application of the NSFR to significant currencies it is important to consider costs and benefits. For instance, enlarging the scope of the NSFR to cover by significant currencies could be perceived as introducing rigidities as it would impose the same structure of assets and liabilities in all currencies in which each bank operates. Some practical issues also remain such as the fact that assets and liabilities in a given currency are not balanced.

Nonetheless, it is crucial to consider that important risks might be caused by mismatches in key foreign currencies. In the last years, the ESRB issued two recommendations to address systemic risks arising from excessive liquidity and maturities mismatches in foreign currencies: Recommendation ESRB/2011/1 on lending in foreign currencies[15], and Recommendation ESRB/2011/2 on US dollar denominated funding of credit institutions[16]. This provides substantial and real evidence of the potential systemic risks stemming from transactions in foreign currencies and the need of macro-prudential policy to act to prevent and mitigate them. An operational NSFR by significant currency would have been a decisive tool in this respect. These two recommendations have shown the importance of currency mismatches, as they can create severe problems in the financial system, and should have raised awareness among national competent authorities and, indirectly, credit institutions, on the need to develop the appropriate macro-prudential tools to address currency mismatches.

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[12] Significant currencies are those which represent at least 5% of the total liabilities of the institution, as defined by Article 415 of CRR.
[13] See http://ec.europa.eu/finance/bank/docs/regcapital/acts/delegated/141010_delegated-act-liquidity-coverage_en.pdf.
[14] See Part Two, paragraph IV of "Basel III: The Liquidity Coverage Ratio and liquidity risk monitoring tools", Jan 2013.
[15] See http://www.esrb.europa.eu/pub/pdf/recommendations/2011/ESRB_2011_1.en.pdf.
[16] See http://www.esrb.europa.eu/pub/pdf/recommendations/2011/ESRB_2011_2.en.pdf.

On the basis of the benefits and costs[17] briefly presented above, a majority of ESRB members strongly call for a NSFR requirement by significant currency. The calibration of such a NSFR requirement shall be undertaken based on substantial analytical work since it must take into account, among others, differences in the foreign exchange markets, the risk of currency mismatch of different institutions and countries, and the use of derivatives to mitigate foreign exchange risk.

A minority of members of the ESRB do not think that a NSFR requirement by significant currency should be imposed. Another member of the ESRB would call for granting explicit powers to national competent authorities to impose a NSFR requirement by significant currency, when necessary.

Before concluding, several ESRB members have raised the issue of the expected consequences from a breach of the NSFR requirement. Here, further clarity is necessary on the supervisory actions to be implemented in the situation of a breach[18], since global shocks on the economic environment, may have direct consequences on a significant part of the EU banking system, leading to a possibly quick deterioration of the NSFR levels for a large subset of EU banks. When these consequences are too punitive, they could raise unintended consequences in terms of financial stability.

Summarizing, members of the ESRB propose:

A. to rely, in general, on the same RSF and ASF weights as agreed by the BCBS,

B. to explicitly mention the NSFR as a potential macro-prudential tool in Article 458 CRR, allowing for a cross-sectional and time-varying application of the NSFR and its components while acknowledging that further analytical work is needed to gain experience on the impact and effects of such a macro-prudential tool,

C. not to introduce preferential treatment for specific business models unless it is proven that there is no risk stemming from maturity mismatch,

D. to maintain the reporting of the NSFR by significant currency, and

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[17] Costs are not limited to operational costs, but would include also those derived from the lack of appropriate tools to address the raising systemic liquidity risk and from the need to act later to mitigate the consequences of the materialisation of the systemic liquidity risk.

[18] These actions would range from regulatory restrictions as for capital buffers complemented with restoration plans to be submitted to competent authorities, to immediate withdrawal of license leading to the resolution of the institution.

E. to apply the NSFR on a consolidated and individual basis, subject to appropriate waivers or exemptions.

A majority of members of the ESRB proposes:

F. to introduce a NSFR requirement by significant currency.

To conclude, let me reiterate that the NSFR requirement is key for the mitigation of systemic liquidity risk in its various forms and would, when appropriately calibrated, contribute to the building of a safer banking system in the EU. Hence, the importance of reflecting the macro-prudential angle in the final proposal to the European Commission on the NSFR requirement, as mandated by Article 510 of the CRR.

For any question and comment, please do not hesitate to contact Francesco Mazzaferro, Head of the ESRB Secretariat (francesco.mazzaferro@esrb.europa.eu, +49 69 1344 7427) or, at a more technical level, Antonio Sánchez (antonio.sanchez@esrb.europa.eu, +49 69 1344 4446), who has been working on this dossier at the ESRB Secretariat.

With kind regards,

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ATC Chair