

# Consultation on further considerations for the implementation of the NSFR in the EU

Joint response PMT/PME/MN



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PENSIOENFONDS VAN DE METALEKTRO

**MN**

# Consultation on further considerations for the implementation of the NSFR in the EU

## Background

Last year the Pension fund for Metalworking and Mechanical Engineering (PMT), the Pension fund for the Metal and Electrical Engineering Industries (PME) and their service provider MN, submitted a joint position paper to the European Commission (EC) on the European Market Infrastructure Regulation (EMIR) (<http://www.mn.nl/media/1370/pmt-pme-and-mn-position-paper-on-emir.pdf>). We support the initiative for a more robust financial market infrastructure, but also express our concerns for substantially increased liquidity requirements end-users will face. Moreover, we also put forward possible unintended consequences (such as a limited number of clearing members) which impede proper functioning of the clearing market.

At the beginning of 2016, Insight Investment Management, APG, PGGM, and MN also expressed their combined concerns to Commissioner Lord Hill of Oareford in an open letter. In the letter our worries were presented, specifically regarding Basel legislation on the Leverage Ratio (LR) and the Net Stable Funding Ratio (NSFR). The current proposals from Bank for International Settlements (BIS) for these measures heavily incentivise banks to require end-users (pension funds) to post Variation Margin (VM) on OTC derivatives transactions in cash. As a consequence, disallowing them to post High Quality Liquid Assets (HQLA) as currently end users do.

The NSFR was introduced by the Basel Committee on Banking Supervision (BCBS) in October 2014. It promotes funding stability and limits over-reliance on short-term wholesale funding. In this respect, the NSFR aims at preventing banks from 'fire selling' assets, which could trigger a downward spiral in prices and could harm confidence in the financial sector. Therefore, the NSFR requires banks to finance their long term activities with a stable source of funding.

On 26 May 2016 the EC published the consultation document on further considerations for the implementation of the NSFR in the EU. We want to seize the opportunity to respond to this consultation, in which the EC seeks stakeholders' views on specific issues that could be raised by the implementation of the NSFR at EU level.

## Introduction

This response to the consultation on further considerations for the implementation of the NSFR in the EU is a joint effort of PMT, PME and their service provider MN. In this paper we briefly state our key messages and provide further explanations and details to the questions asked in the consultation.

## Key messages

- Recognition of HQLA

Derivatives Receivable have a 100% Required Stable Funding (RSF), which can be offset if cash is posted as collateral, but not if HQLA are posted instead. We propose that HQLA posted as collateral should be able to offset a bank's Derivatives Receivable.

- 20% RSF add-on on gross derivatives exposure is extensive

Gross derivatives exposures are quite extensive for banks, although their net positions are much smaller. Stable funding is however required for their (long-term) gross exposure. The 20% RSF add-on should, in our view, be more proportionate and commensurate to the risk profile of the overall derivatives position to a bank. Therefore, the RSF should not be based on gross derivatives exposure but on net derivatives exposure instead.

- RSF for short term repurchase transactions is disproportionate

Repurchase transactions less than 6 months are defined as short term. Depending on their collateral these repo-transactions require stable funding of 10%-15% under NSFR legislation. This funding requirement is significant and will most probably reduce liquidity in the repo market due to higher funding costs to end users, such as pension funds. A reduced liquidity in the repo market is very detrimental to pension funds. Pension funds will face higher liquidity requirements as result of cash Variation Margin on derivatives positions in a cleared space, but also due a shift to Cash Credit Support Annexes (CSA's) for derivatives transactions in the bilateral market.

### **Joint response of PMT, PME and MN to the DG FISMA consultation paper on further considerations for the implementation of the NSFR in the EU**

*1. In light of previous consultations, could you describe more specifically, if appropriate, the specific activities, transactions and business models where you have evidence that the implementation of the NSFR could have an excessive impact or important unintended consequences?*

We believe there are unintended consequences regarding the use of derivatives and collateral for pension funds. Pension funds use derivatives to mitigate risks they naturally have, mostly arising from interest rates, inflation and foreign currencies. Moreover, they have agreed with their corresponding bank counterparties Credit Support Annexes (CSA's), which enable them to provide HQLA as collateral if derivative positions have a net negative value.

In this specific case, if there is a negative value for the net derivative position for a pension fund with a corresponding bank counterparty, the bank has a derivatives receivable on its balance sheet. However, the NSFR legislation works unfavorably for the pension fund. The NSFR legislation only allows the derivatives receivable position to be offset by cash that is posted as collateral by the pension fund, *not* high quality government bonds (HQLA). Therefore CSA's for trading OTC-derivatives with bank counterparties will be forced to cash only in the market.

This is probably an important unintended consequence, because the posted HQLA as collateral by pension funds can easily be converted to cash by banks, either applying the repo-market or central bank. Banks also have the opportunity to apply haircuts on the posted

HQLA by pension funds to further increase the value of the collateral, resulting in a similar risk profile to a bank for HQLA collateral compared to cash collateral.

We propose that HQLA posted as collateral must be allowed to offset the RSF of a bank's Derivatives Receivable.

*2. If a respondent is a bank, could you please quantify the level of your expected shortfall of stable funding, the changes to the composition of your balance sheet that may result from meeting the NSFR and what the impact of these changes may be on the European economy?*

We are pension funds / service provider, therefore this question is not applicable to us.

*3. In light of previous consultations, could you provide substantiated evidence about possible issues caused by the application of the BCBS NSFR standard to derivative transactions at European level and which have not been taken into account at Basel level? If yes, what alternative treatment would you propose for NSFR calculation purposes to deal with the funding needs arising from derivatives transactions? If possible, please provide the impact on your institution of the alternative treatment you propose (as compared to the BCBS standards).*

In the answer to question 1 we raised the issue that HQLA posted as collateral cannot offset a bank's Derivatives Receivable. The consequence of the current NSFR legislation (also Leverage Ratio legislation) is a movement in the derivatives market to cash only CSA's, and successively a need for (much) higher cash buffers for pension funds and other end users. This increases their liquidity risks and requires them to hold higher cash buffers and /or use the repo-market more extensively.

The specific question raised here; "What alternative treatment for NSFR calculation to deal with the funding needs arising from derivatives transactions?", can be answered with the *recognition of HQLA* posted as collateral, to offset the RSF of a bank's Derivatives Receivable.

Quantitative impact:

Currently, pension funds can deliver high quality government bonds as collateral on their derivative positions. These bonds deliver investment return on the pension fund portfolio, and pension funds tend to be fully invested.

However, if 4% on investment portfolio level in cash is required to be able to meet capital calls for the market movements on the derivatives portfolio (variation margin) this will result in a cost:

If a 60 billion euro pension fund holds a buffer of 4% cash and normally has a 5% return annually on its investment portfolio, the (indirect) cost will be:

$4\% * 5\% * 60 \text{ billion euro} = 120 \text{ million euro}$  each year "lost" earnings to the pension fund which alternatively could have been used for adequate pension to retirees.

If a 60 billion euro pension fund would use the short term repo-market (less than 6 months) for funding purposes it's also impacted by the NSFR. The NSFR will introduce ca. 10% RSF on short term repo transactions. If a bank would require a 100 basis point (1%) funding cost, the increased cost to the pension fund due to NSFR will be:

$10\% * 1\% = 10$  basis points on every repo transaction.

(For example, this is a direct cost of 10.000 euro on a 120 million euro 1 month repo-transaction).

*4. More specifically, regarding the 20% RSF factor applicable to gross derivatives liabilities, do you think it would be possible and appropriate to develop a more risk-sensitive approach that would take better account of the funding risk arising from banks' derivative activities over a one-year horizon? In that case, what could be this approach? Do you think that the use of the SA-CCR could provide an appropriate measure? If possible, please provide the impact on your institution of the alternative treatment you propose (as compared to the BCBS standards).*

We do think there could be a more risk sensitive approach regarding the 20% RSF add-on applicable to gross derivatives exposure. Gross derivatives exposures are (naturally) quite extensive for banks, although their net positions are (much) smaller in comparison. Stable funding is however required in the NSFR regulation based on gross exposure. The 20% RSF add-on should, based on our view, be more proportionate and ideally commensurate to the risk-profile of the overall derivatives position to a bank over a specified period of time.

Therefore, in our view, the 20% RSF add-on should not be based on gross derivatives exposure, however on <i>net</i> derivatives exposure instead.
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The SA-CCR in its current form doesn't allow IM or VM in HQLA to offset both cleared and non-cleared trades. Therefore, we think the SA-CCR is not an appropriate measure at the moment, because it disproportionately penalises one-directional European pension fund derivative portfolios.

*5. If you propose special treatment for specific activities (eg hedging instruments, clients clearing...), how would you define these activities?*

Pension funds distinguish themselves from other players on the European financial markets, in the sense that they do not add additional risk to the financial system. On the contrary, they contribute largely to financial stability because among others, they finance long term investment needs. In addition, pension funds respond differently to macroeconomic risks in funded systems, because pension scheme participants cannot withdraw their funds or assets on short notice, allowing for a stable funding basis. Regulation designed to enhance financial stability, such as the NSFR and the Leverage Ratio, should take into account the specific role of pension funds as financial stabilizer and as investors in the real economy. Moreover, pension funds apply bilateral or cleared OTC derivative transactions to mitigate risks to their fund.

Therefore, due to the indirect impact of the NSFR legislation on pension funds the EC could give favorable treatment to derivative and financing transactions from pension funds. This with pension fund's objective in mind of providing adequate old age pension to retirees.

## **Short term transactions with financial institutions**

*6. In light of previous consultations, could you provide substantiated evidence about possible issues caused by the application of the BCBS NSFR standard to short term transactions with financial institutions at European level and which have not been taken into account at Basel level? If yes, what alternative treatment would you propose for NSFR calculation purposes to deal with the funding needs arising from short-term transactions with financial institutions? If possible, please provide the impact on your institution of the alternative treatment you propose (as compared to the BCBS standards).*

Repurchase transactions less than 6 months are defined as short term. Depending on their collateral these repo-transactions require stable funding of 10%-15% under NSFR legislation. This funding requirement is significant and will most probably reduce liquidity in the repo market due to higher funding costs to end users, such as pension funds. A reduced liquidity in the repo market is very detrimental to pension funds. Pension funds will face higher liquidity requirements as result of cash Variation Margin on derivatives positions in a cleared space, but also due a shift to Cash Credit Support Annexes (CSA's) for derivatives transactions in the bilateral market. See for a quantitative impact our response to question 3.

*7. If you propose special treatment for specific activities (e.g. client's short facilitations activities, prime brokerage businesses...), how would you define these activities?*

See question 5. Moreover a possible solution would be to reduce the 10-15% RSF to 0% as a special treatment for these specific activities.

### **Application of the proportionality principle**

*8. What do you believe the appropriate level of application of the NSFR to be? Is there scope to make the NSFR requirements more proportionate and, if so, on the basis of what criteria?*

We have no opinion on this matter.

*9. In particular, what criteria could be used to define institutions with a "low liquidity risk profile"? What simplified metrics (e.g. core funding ratio close to loans to deposits + capital) could be used to identify these institutions? Should certain institutions be completely exempted from the NSFR and on what basis?*

We have no opinion on this matter.