Growing Asia's Markets

23 December 2016

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By hand and e-mail: kdkemp@hkma.gov.hk

Dear Ms. Kemp,

Re: Response to Consultation Paper (CP 16.02) on the Net Stable Funding Ratio

The Asia Securities Industry & Financial Markets Association (ASIFMA)[1] and its members support the underlying policy goals of the Net Stable Funding Ratio (NSFR), including its core objective of requiring banks to develop and maintain sustainable funding structures.

So we appreciate the HKMA's efforts to ensure that its draft guidelines are consistent with the Basel Committee on Banking Supervision's (BCBS) final standard, and welcome the opportunity to respond to the HKMA's draft standard for local implementation of the NSFR.

As the HKMA considers how to implement this global standard in Hong Kong, we encourage it to examine the impact of the final NSFR on Hong Kong's economy, and as one of Asia's financial centres, on the region's economic development. We appreciate the HKMA's commitment to running several rounds of Quantitative Impact Studies (QIS) to guide calibration of the requirement before finalising the framework.

Notwithstanding our support for the NSFR's underlying goals, we would like to note our concerns about the BCBS's standard and its treatment of repo and interlinked transactions. The first part of this letter details how elements of the proposed NSFR stand to reduce capital market activity and increase costs for end-users and investors.[2]

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[1] ASIFMA is an independent, regional trade association with over 80 member firms comprising a diverse range of leading financial institutions from both the buy and sell side, including banks, asset managers, law firms and market infrastructure service providers. Together, we harness the shared interests of the financial industry to promote the development of liquid, deep and broad capital markets in Asia. ASIFMA advocates stable, innovative, competitive and efficient Asian capital markets that are necessary to support the region's economic growth. We drive consensus, advocate solutions and effect change around key issues through the collective strength and clarity of one industry voice. Our many initiatives include consultations with regulators and exchanges, development of uniform industry standards, advocacy for enhanced markets through policy papers, and lowering the cost of doing business in the region. Through the GFMA alliance with SIFMA in the United States and AFME in Europe, ASIFMA also provides insights on global best practices and standards to benefit the region.

[2] Oliver Wyman study, "Impact of NSFR on capital markets," January 2015.

The second part of this letter is reserved for our questions and concerns specific to the HKMA consultation, and is focused on the modified NSFR and the application of the NSFR to branches of foreign banks and category 2 institutions.

General concerns about the BCBS standard

ASIFMA, through its umbrella organisation, the Global Financial Markets Association (GFMA), has conveyed to the Basel Committee its reservations on the NSFR standard and its impact on capital markets. In responses to European Commission and U.S. agency consultations on local implementation of NSFR submitted in the summer of 2016, we and our trade association partners (the Association of Financial Markets in Europe [AFME][3] and the Securities Industry and Financial Markets Association [SIFMA][4] in the United States as well as the GFMA) have highlighted how the NSFR raises costs for end-users and reduces liquidity in financial markets. Those effects will likely be amplified in Asia's developing financial markets.

Any evaluation of NSFR's impact should take into account how banks allocate regulatory capital, funding and liquidity costs internally, as required by BCBS standards. Although exact practices vary by institution, as a general principle banks evaluate internal business units' profitability against all applicable prudential standards, including the NSFR, which may have a significant impact on banks' appetite for capital markets activities.

Banks operating globally are especially cognisant of the need to be rigorous about allocating and minimising costs – limiting the ability of even those banks with an NSFR surplus to subsidise the cost of funding a capital markets franchise with, for example, retail division Available Stable Funding (ASF) surpluses.

While end-users may or may not be able and willing to absorb incremental cost increases in capital markets services – which cannot be the prudential objective of the NSFR – we believe the larger effect on financial markets will be lower activity and greater volatility. This is an especially pressing concern for developing markets in Asia, which are less deep and liquid than those in the U.S. or Europe.

In addition to our points below on repurchase agreements and interdependent assets and liabilities, we support the response by the International Swaps and Derivatives Association (ISDA) on how NSFR treats derivatives, including ISDA's proposals on recognising the securities variation margin required by banks and the 20% Required Stable Funding (RSF) add-on derivatives payables.

Repurchase agreements (repo)

ASIFMA recommends that further consideration be given to the ASF and RSF factors assigned to repo transactions under the proposed framework.

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[3] Association of Financial Markets in Europe, International Swaps and Derivatives Association and Institute of International Finance, Response to European Commission consultation paper "On Further Considerations for the Implementation of the NSFR in the EU," https://www2.isda.org/attachment/ODQ3OQ==/AFME-ISDA-IIF%20EC%20NSFR%20Response.pdf

[4] The Clearing House Association, the Securities Industry and Financial Markets Association, the Financial Services Roundtable, the American Bankers Association, the Institute of International Bankers and the CRE Finance Council, Response to Multiple Agencies' "Notice of Proposed Rulemaking – Net Stable Funding Ratio: Liquidity Risk Measurement Standards and Disclosure Requirements," http://www.sifma.org/comment-letters/2016/sifma-and-other-associations-submit-comments-to-multiple-agencies-on-net-stable-funding-ratio/

Repo transactions play a vital role in the financial system and underpin the functioning of primary and secondary capital markets as well as short-term money markets. Developing a "classic" repo market is an important step in deepening Asia's capital markets and the economies that rely on them. Deep, liquid repo markets help establish a benchmark yield curve – an important prerequisite for price certainty and transparency in capital markets. They foster the proliferation of more experienced broker-dealers and market makers and stimulate the development of hedging tools for better risk management.

However, the adoption of the current NSFR proposal based on the BCBS standard could run counter to the HKMA's goal of developing a deeper, more liquid bond market in Hong Kong, as well as deeper markets throughout Asia. Small asymmetries in ASF and RSF factors (e.g. 10-15%),[5] as specified in the HKMA's consultation based on the Basel Committee standards, would raise costs for what is already a high-volume, low-margin business that is shrinking due to the impact of the leverage ratio, and may be contributing to a decline in market liquidity.[6]

We understand that the asymmetry between the ASF and RSF factors is designed to disincentivise bank interaction with the unregulated financial sector, such as hedge funds. However, we note that the Basel Committee has provided no evidence or guidance as to what the "right" amount of interaction is, or how the proposed asymmetry in the NSFR would achieve it. The proposed treatments under the NSFR are therefore particularly disproportionate and could have unintended consequences.

The European Commission (EC) is already taking steps to reduce the impact NSFR stands to have through the repo market on Europe's economic growth and the unintended consequences on end-users. On 23 November, it published legislative proposals revising its Capital Requirements Regulation and Directive (CRR/CRD V).[7] The NSFR is a key component of that legislative package.

The EC proposed, for example, setting a 0% RSF on Level 1 high-quality liquid assets (HQLA), compared with 5% under the BCBS standards. This proposal is consistent with the treatment of those assets under the existing Liquidity Coverage Ratio. The EC further proposed lowering the RSF for secured lending outlined in the BCBS standard; in the EC's legislative proposal, the RSF on secured lending is 5% on Level 1 HQLA – versus 10% in the BCBS standard – and 10% on level 2A HQLA – versus 15% – to preserve market efficiency given the central role of secured lending in the financial system.

The EC's approach represents a welcome step in the right direction. We remain concerned, however, that its proposed changes are still not enough to mitigate the NSFR's impact on the repo market. As an alternative to the current Basel Committee approach, ASIFMA recommends that global regulators consider a setting of 0% RSF for Level 1 HQLA, which would minimise the effects of implementing NSFR on government bond markets – particularly less-liquid markets in Asia – and less-developed repo markets. Furthermore, ASIFMA suggests that the asymmetry between ASF and RSF factors be eliminated, or re-proposed with analysis that supports how it might achieve the intended outcome. Another, less desirable, option would be to apply the asymmetry of ASF and RSF factors for repo transactions only to agreements with non-regulated financial entities.

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[5] For more information, please refer to page 13 in the International Capital Market Association, "Impact of the Net Stable Funding Ratio on Repo and Collateral Markets," March 2016, http://www.icmagroup.org/assets/documents/Regulatory/Repo/ERCC-NSFR-230316.pdf

[6] Global Financial Markets Association and International Institute of Finance, Response to IOSCO's Public Comment on Examination of Liquidity of the Secondary Corporate Bond Markets, October 2016.

[7] European Commission, Proposals to amend rules on capital requirement, 23 November 2016, http://ec.europa.eu/finance/bank/regcapital/crr-crd-review/index_en.htm

Interdependent assets and liabilities

Without exempting specific capital markets activities, several aspects of the global NSFR framework will severely restrict banks' ability to facilitate client financing, investing and hedging – and thereby hinder capital markets' development and their ability to support economic growth.

The NSFR framework requires banks to use long-term funding for transactions that are already well-funded and short-term in nature, which would materially increase transaction costs without necessarily improving liquidity-risk management. A range of interdependent transactions or pass-through facilitation trades would need to be funded – often on long-term basis, materially increasing the costs of such transactions. Such increased costs are likely to be passed on to investors and end-users.

ASIFMA proposes neutral treatments for certain activities, including:

- intercompany funding;
- export financing;
- derivatives hedges/initial margin;
- clearing of client trades;
- segregation and custody of customer assets; and
- facilitation of client and firm short transactions.

These transactions support hedging, clearing and trading by long-term investors – activities that support the real economy.

Globally, we have urged regulators to treat the funding of these capital market activities neutrally so that banks are able to maintain market liquidity and continue offering clients efficient, tight pricing. This neutral treatment will help mitigate some of the adverse impacts of the NSFR standard while strengthening banks' management of liquidity risk.

HKMA's current proposal does not contemplate exemptions for neutral funding treatment of interdependent assets and liabilities. This is inconsistent with the approach being adopted elsewhere, including the Monetary Authority of Singapore's (MAS) consultation on its local implementation of NSFR and the EC's proposed CRD/CRDV package. Both of those jurisdictions propose allowing banks to set ASF and RSF at 0% for certain transactions if they can demonstrate that these transactions meet the listed criteria for interdependent items. We recommend that HKMA consider a similar carve-out that provides for the activities listed above, which would in turn support capital market development and economic growth.

Other concerns specific to the HKMA's NSFR consultation paper

In addition to our concerns about the Basel Committee's NSFR standard, there are a number of additional aspects specific to the HKMA's consultation we hope it will reconsider or clarify. In particular, we are concerned about the application of NSFR requirements to branches of global financial institutions and category 2 institutions.

We appreciate and support the fact that HKMA proposes in Articles 7 and 8 to potentially apply a modified NSFR to branches of foreign financial institutions and category 2 institutions. We understand that Hong Kong is a host jurisdiction to nearly all of the global systemically important banks, and that some are also systemically important to Hong Kong.

However, many banks rely on branches with centralised global liquidity and funding management to holistically address home and host country liquidity and funding needs. Requiring banks to fragment that liquidity and funding into multiple, independent pools managed at the group level would complicate those institutions' ability to maintain the kind of global liquidity and funding management objectives that are a source of strength in times of stress. Affected banks would no longer have the discretion to use liquidity and funding trapped locally to address needs in other offices and subsidiaries. Global financial institutions are subject to strict liquidity and funding requirements at the group level and apply stress tests to their consolidated organisations – including their Hong Kong operations – under a variety of short-term, acute stress scenarios as well as medium-term, general stress scenarios.

Access to wholesale funding is typically not fragmented across all branches, but rather managed in funding hubs and then distributed as needed within the bank. Furthermore, the NSFR is intended to be a stable funding metric, and is therefore not subject to short-term, acute liquidity stresses that may require immediate action. This makes it even less suitable for applying local requirements on branches; a bank can act within a year to ensure a balanced funding profile. If a bank's branches were all subject to the requirements proposed in the HKMA's consultation, however, managing funding across the group could become inefficient.

The HKMA's proposal to include branches of foreign banks and category 2 institutions within the scope of its NSFR implementation is also inconsistent with similar measures elsewhere in the region. The Australian Prudential Regulatory Authority has proposed applying the NSFR only to locally incorporated Authorised Deposit-taking Institutions subject to the Liquidity Coverage Ratio. The MAS has proposed applying the NSFR only to domestic systemically important banks (D-SIBs).

Exemption

Further to our concerns on the applicability of modified NSFR to foreign bank branches and category 2 institutions, we would appreciate further clarity around the exemption standards outlined in Section IV ("Modified NSFR") under which the HKMA would apply its power to require a locally-incorporated Authorised Institution (AI) to comply with the modified NSFR, especially for activities outside of Hong Kong.

We hope that HKMA will outline a clearer process for seeking an exemption to the modified NSFR requirement. We recommend that the HKMA include details such as the documentation required, key deadlines and dates of determination, the effective period of the exemption and other criteria that the HKMA will consider when deciding whether to grant an exemption. We also suggest that the exemption be effective for at least 12 months. If a branch or category 2 institution is subsequently required to comply with the modified NSFR requirement, we suggest that the requirement be subject to an initial, six-month transition period.

Computation and notification

With regard to the implementation of the NSFR to branches of foreign banks and category 2 institutions, we would appreciate clarity from the HKMA on whether the NSFR – especially the modified NSFR – will be imposed on an all-currency basis only as it is in the MAS's consultation on implementation of the NSFR in Singapore.

We also request further guidance on certain aspects of the proposed computation and reporting requirements under the modified NSFR. In Article 25, HKMA proposes that banks subject to the modified NSFR maintain a modified NSFR of not less than 75% on average each month. It seems unclear whether that level would be calculated as an average over the month, or whether it would need to be maintained each day during the month. Put differently, would a bank be deemed below the 75% threshold if its NSFR averages 75% for the month but dips below it at any point within the month?

The HKMA proposes that a "self-rectification" mechanism (as described in Article 20) not be available for branches of foreign banks and category 2 institutions subject to modified NSFR. We would appreciate further detail on why only category 1 AIs can benefit from this "self-rectification" mechanism, as well as from a temporary relief period to address any potential NSFR shortfall. We recommend that the HKMA consider allowing category 2 institutions and branches of foreign banks subject to modified NSFR to adopt the same "self-rectification" mechanism proposed for category 1 institutions to take into account rectification actions before the end of each month.

In addition, we would like to seek clarity regarding the timing and frequency of reporting required for branches of foreign banks and category 2 institutions. For example, it is unclear whether these branches and category 2 institutions will be required to submit modified NSFR figures to the HKMA monthly, or whether they should submit their monthly data each quarter. It would also be helpful to learn whether a branch or category 2 institution would be permitted to run modified NSFR by referencing specific days during a month as opposed to each working day. The HKMA also does not specify details for a notification process when an institution subject to modified NSFR falls below the minimum required level. We hope for further clarity about how such an event should be communicated to the regulator, and whether there is a preferred format and timeframe for reporting.

Structure of modified NSFR

In Annex 2, the HKMA specifies that reporting institutions are required to slot respective items into different time buckets according to their remaining maturity in order to calculate NSFR. We would appreciate clarification on whether that remaining maturity should always be determined with reference to contractual maturity.

Doing so may not always be appropriate. From an accounting perspective, for example, derivatives receivables and payables should generally be considered short-term assets and liabilities regardless of their remaining maturity. That is because institutions may be able to close out the positions before their contractual maturity date. Conversely, there are cases in which the corresponding funding carries an embedded option that enables the reporting institutions or customers to accelerate the funding flow before maturity even if neither side intends to exercise the option (i.e. evergreen funding arrangements among group companies where there is an option to allow early termination of trade, but the institution intends to keep the fund rolling until final maturity).

On specific RSF items, we would appreciate clarity regarding "On-balance sheet assets (excluding liquefiable assets defined under LMR)" and whether all assets not considered liquefiable under LMR calculation should be reported, including fixed assets and other long-term investments. Please also confirm whether lease commitments should be included as "Off-balance sheet items" in the calculation of modified NSFR. We would also appreciate clarity on whether reporting requirements under the modified NSFR will follow the new accounting standards for leasing (HKFRS 16).

We welcome the opportunity for continued engagement with the HKMA as it considers this important regulation. If you have further questions or would otherwise like to follow up, please contact Wayne Arnold, ASIFMA Executive Director and Head of Policy and Regulatory Affairs at warnold@asifma.org or +852 2531 6560.

Sincerely,

Mark Austen
CEO
ASIFMA

Cc: Richard Chu, Acting Head (Banking Policy)