Discussion Note:

European Banking Authority report on aspects of the Net Stable Funding Ratio Framework

March 2024

AFME and its members have noted with interest the publication of the report from the EBA on specific aspects of the NSFR in accordance with Article 510 (4), (6) and (9) of the Capital Requirements Regulation.

One significant development is the EBA's suggestion that RSF factors for reverse repos should revert to the BCBS levels of 10% and 15% for less than 6 month transactions secured by level 1 HQLA and non-Level 1 HQLA respectively.

The suggested changes to the NSFR RSF factors for reverse repos, if implemented, could have multiple unintended consequences for primary and secondary dealing in securities given the role of repo markets at the centre of the financial system, including an increased cost for European governments wishing to finance their economic needs. This has been recognised previously by a range of policymakers in the objectives to the introduction of the transitional periods for the NSFR under the negotiation of the Capital Requirements Regulation and in response to the global BCBS' assessment of NSFR regulations in Europe. It would also be inconsistent and a significant outlier to the more realistic treatments in other major jurisdictions, including the US and UK[1], at a time when monetary policy is tightening and when further debt issuance is needed.

By way of background, market makers in sovereign securities generally earn very marginal revenues and yet require large balance sheet support. The above proposed change in stable funding requirements would significantly increase the funding costs for the sovereign bonds market making activity. To the extent that a bank, or a capital markets franchise within a bank, is constrained by RSF factors applied to reverse repos under the NSFR, the bank will have to consider adjustments to its inventory in light of the relative return on equity generated by sovereign market making. Reducing or eliminating primary dealer activity will be a logical solution where the bank's existing revenue from the activity is already low and the incremental costs of NSFR funding charges create an economic incentive to reduce inventory.

Our analysis shows that across thirteen banks that participated in a survey, an increase in the RSF factor from 0% to 10% for reverse repos secured by Level 1 HQLA, would result in additional long term funding requirements in excess of €80 billion and that in some instances NSFR ratios could be reduced by over 10% for those institutions focused more specifically on market making activities. Based on the survey, we estimate that the size of the sovereign bond reverse repo market impacted by this change is in excess of EUR 800bn. While we acknowledge the analysis the EBA has undertaken, we believe that our work helps to give more perspective of the likely impacts on the banks most involved in reverse repo transactions to support market making and debt issuance and indicates the importance of assessing impact at the business unit level (the level at which banks assess economic viability, and

[1] US Requirements: Paragraphs [249.106(a)(1)(vii)] and [249.106(a)(3)(ii)], UK requirements continue to be derived from CRR Articles [428r1(g)] and [428s1(b)].

decide whether to continue to scale back an activity). At a more technical level, we would note that the proposed treatment would also lead to negative impacts on repo inventories owing to inconsistencies with the LCR.

While end-users may (or may not) be able and willing to absorb some incremental cost increases, which cannot be the prudential objective of the NSFR, in capital markets services we believe that the larger effect will be a contraction of financial markets activity and increased financial market volatility. If the cumulative effects of NSFR and other requirements are not manageable, a bank will reduce its inventories impairing market liquidity. Less liquid markets in turn will reduce issuers' access to investors through reduced participation, less efficiencies and increased costs. In addition to the increased costs for government debt issuance, this would clearly also work to the detriment of the on-going development of capital markets in Europe.

We strongly recommend therefore that the EC takes swift action to introduce a legislative proposals ahead of the 28 June 2024 deadline to ensure that RSF can remain at the current levels of 0% and 5%, for less than 6 month transactions secured by level 1 HQLA and non-Level 1 HQLA respectively

AFME and its members would welcome the opportunity to discuss the above changes and facilitate the EC in the decision making process.

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About AFME:

AFME represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. We advocate stable, competitive, sustainable European financial markets that support economic growth and benefit society.

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