MEMORANDUM

TO:	Public File - Notice of Public Rulemaking: Net Stable Funding Ratio: Liquidity Risk Measurement Standards and Disclosure Requirements (RIN 3064-AE44) ("Net Stable Funding Ratio NPR")
FROM:	Sue Dawley, Senior Attorney, Legal Division
DATE:	September 1, 2016
SUBJECT:	Meeting with Representatives from Securities Industry and Financial Markets Association ("SIFMA")

On July 27, 2015, FDIC staff, together with staff of the Board of Governors of the Federal Reserve System and the Office of the Comptroller of the Currency, met with representatives of SIFMA.

Representatives from SIFMA presented their concerns and views related to a future Net Stable Funding Ratio rulemaking action, including the impact of the treatment of derivatives, and presented the attached information.

The NSFR NPR was issued in the Federal Register of 81 FR 35124 (June 1, 2016).

The FDIC representatives at this meeting were:

- Karl Reitz, Corporate Expert, Capital Markets/RMS
- Irina Leonova, Senior Policy Analyst, Capital Markets/RMS
- Eric Schatten, Policy Analyst, Capital Markets/RMS
- Andrew Carayiannis, Financial Analyst, Capital Markets/RMS
- Nana Ofori-ansah, Policy Analyst, Capital Markets/RMS
- Greg Feder, Counsel, Legal Division
- Sue Dawley, Senior Attorney, Legal Division

SIFMA's representatives in attendance at the meeting were:

- Rajashree Datta, Goldman Sachs
- Elizabeth Ewing, Goldman Sachs
- Keith Evan Huebsch, Bank of America
- Gonzalo Martin, Citigroup
- Carter McDowell, SIFMA
- Andrew Nash, Morgan Stanley
- Mason Reeves, Bank of America
- Elisha Wiesel, Goldman Sachs

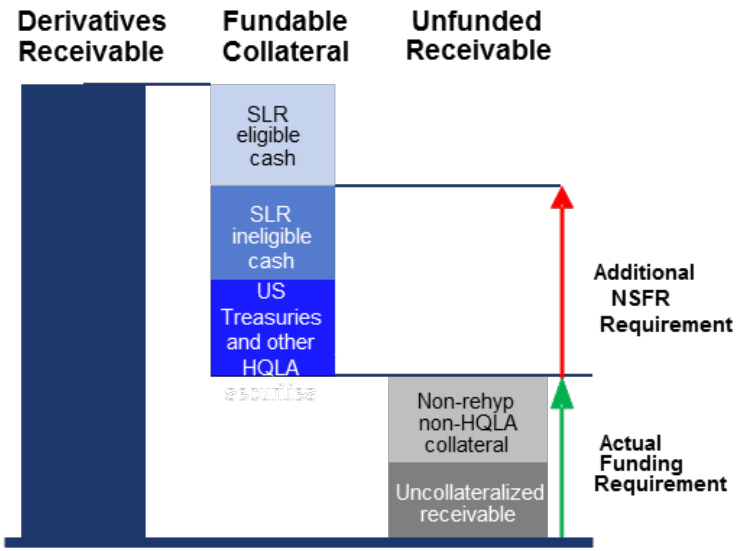
Net Stable Funding Ratio
Derivatives

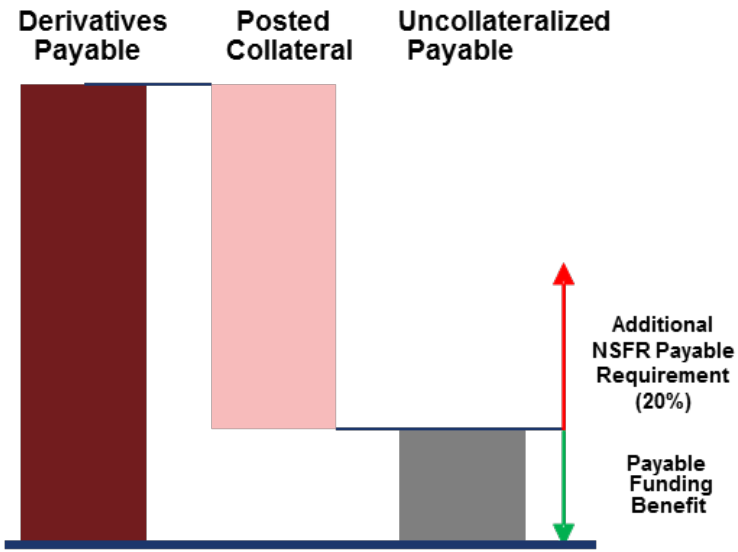
- The October 2014 Basel NSFR Framework adopted a new derivatives methodology that had not been previously considered in consultative documents, focusing on three elements:
  - 100% RSF applied to derivative assets, calculated under netting principles that disqualify much variation margin received;
  - 100% RSF applied to 20% of derivatives liabilities; and
  - 85% RSF applied to initial margin posted in connection with derivatives.
- Some features of this approach have raised concerns:
  - Application of Basel leverage ratio (LR) netting principles to variation margin received, which has the effect of disqualifying all non-cash variation margin as well as cash variation margin that does not meet the prescriptive standards of the leverage ratio;
  - The 20% derivatives liabilities appears to be a new incremental funding requirement beyond the current balance sheet exposure; it would be helpful to understand the rationale for this requirement and and ensure that the calibration is appropriate; and
  - Banks receive no credit for initial margin received from counterparties, even when such collateral can be re-used to meet initial margin posting requirements, resulting in a distorted presentation of initial margin funding sources and requirements.
- We believe that it is worth considering whether technical refinements could be made to the NSFR to better capture derivatives funding sources and requirements without departing in large ways from the October 2014 framework.
- This document contains discussion ideas for potential improvements in the NSFR derivatives methodology.

Net Stable Funding Ratio

Derivatives - Overview of Basel III Treatment

Item	Basel Framework	Considerations	Proposal
Net Derivative Receivable / Payable	■ 100% RSF for net receivable (net of payables) — NSFR Derivative Asset = Derivative Asset – Cash Collateral VM that meets Basel III leverage ratio netting criteria (LR) ■ Net Payable can offset receivable RSF after accounting for all posted VM — NSFR Payable Liability = Derivative Liability – (Total VM collateral posted) ■ 0% ASF for payable amount above receivable	■ LR cash netting creates RSF volatility and is not related to funding ■ NSFR ignores funding value of high quality securities collateral ■ Potentially negative impact for asset liquidity, due to exclusion of high quality securities collateral received	1. Recognize all rehyp cash collateral 2. Recognize rehyp HQLA securities collateral where collateral meets regulatory margin standards
20% Gross Payable RSF	■ 20% RSF on total payable post counterparty netting gross of variation margin posted	■ Payable add-on (20%) does not incentivize managing derivatives volatility and does not appropriately capture funding risk	3. Apply 20% factor only as a floor
Initial margin	■ 85% RSF for initial margin posted ■ No consideration of rehyp IM held	■ Rehypothecatable initial margin held can be used to meet initial margin positing requirements	4. Allow to offset rehyp IM held from IM posted, before applying the 85% RSF





Net Stable Funding Ratio

Derivatives – Regulatory Guidance for SLR Netting Requirement

- **Final FRB SLR rule:**
  - 3.) The variation margin transferred under the derivative contract or the governing rules for a cleared transaction is the full amount that is necessary to fully extinguish the net current credit exposure to the counterparty of the derivative contracts, subject to the threshold and minimum transfer amounts applicable to the counterparty under the terms of the derivative contract or the governing rules for a cleared transaction;

- **Final FRB SLR preamble:**
  - The proposed conditions under which cash collateral may be used to offset the amount of a derivative contract were developed to ensure that such cash collateral is, in substance, a form of pre-settlement payment on a derivative contract.
  - With respect to the third proposed criterion, commenters expressed the view that there may be occasional short-term differences between the amount of the variation margin provided and the mark-to-fair value of derivative contracts. For example, it is a common practice for a morning margin call to be based on the mark-to-fair value of a derivative contract based on the previous end of business day's valuation. The commenters recommended that the agencies permit such small, temporary differences between the amount of variation margin provided and the current mark-to-fair value, so long as it is clear that the contract governing such transactions requires variation margin for the full amount of the current credit exposure. The agencies agree with the commenters that such temporary differences should not invalidate recognition of the variation margin already received and as such, a morning margin call based on the mark from the end of the previous day should be considered to satisfy this criterion. Therefore, the agencies are clarifying that cash variation margin exchanged on the morning of the subsequent trading day would meet the third criterion for cash variation margin.
  - As noted in the preamble to the proposed rule, the regular and timely exchange of cash variation margin helps to protect both counterparties from the effects of a counterparty default. The proposed conditions under which cash collateral may be used to offset the amount of a derivative contract were developed to ensure that such cash collateral is, in substance, a form of pre-settlement payment on a derivative contract. This approach is consistent with the design of the supplementary leverage ratio, which generally does not permit banking organizations to use collateral to reduce exposures for purposes of calculating total leverage exposure. The proposed conditions also ensure that the counterparties calculate their exposures arising from derivative contracts on a daily basis and transfer the net amounts owed, as appropriate, in a timely manner. Therefore, with the clarifications noted above, the agencies are finalizing the criteria as proposed for permitting the use of cash variation margin to offset the mark-to-fair value of derivative contracts.

Net Stable Funding Ratio

Derivatives – Leverage Ratio Cash Netting Creates RSF Volatility and Is Unrelated to Funding

Proposal (1): Recognize all re-hypothecatable cash collateral received

- NSFR does not recognize a large portion of cash collateral, since NSFR only allows cash that meets the Basel III Leverage Ratio (LR) netting criteria
- LR is not the right metric for determining funding value as per table below. For example, considerations of the actual capability to re-hypothecate collateral are ignored in LR. Basel margin rules, by contrast, generally recognize any cash collateral received as exposure-reducing
- The LR criteria, if applied in NSFR, should be tailored appropriately. LR netting criteria disallows collateral as soon as an agreement exhibits a minimal amount of under-collateralization which introduces significant volatility into the NSFR metric that is not related to funding risk:
  - While it may be appropriate to not give credit for collateral that has not been received due to settlement timing or a dispute, it is problematic that NSFR ignores the entire remaining cash balance received from the same counterparty, e.g. a one dollar collateral shortfall could invalidate 3bn of cash collateral that the bank uses to fund the receivable (see example)
  - This "all or nothing" criteria ignores the real funding value of cash collateral received from a counterparty[1]
  - Additionally, this will drive huge day over day swings in the derivatives NSFR requirement and does not reflect true funding value
- The under-collateralization criteria as currently applied is not appropriate for the Leverage Ratio or NSFR calculation; however, the impact is more problematic for the NSFR, where it has a larger relative impact due to the funding value of cash collateral received

LR cash collateral netting criteria vs. funding value of collateral

Criteria	Required for LR eligibility	Req. for Funding
Not under-collateralized	✓	×
Cash Only	✓	×
Enforceable MNA and collateral	✓	×
Daily Margining	✓	×
Marg. and settlement ccy the same	✓	×
Non-segregated	✓	✓
Operational capability to rehyp	×	✓
Contractual right to rehyp	×	✓

Example – Large derivatives portfolio with zero threshold CSA

	T	T+2	DoD variance
Derivative NPV	$3,000mm	$3,000mm	-
Cash Collateral	$2,999mm	$3,000mm	$1mm
Actual funding req.	$(1)mm	-	$1mm
SLR eligible collateral	-	$3,000mm	$3,000mm
NSFR RSF	**$3,000mm**	**-**	**$(3,000)mm**
Proposed RSF	*$1mm*	*$0mm*	*$1mm*

[1] *Extract from BCBS 270 , Art 25*
"Variation margin exchanged is the full amount that would be necessary to fully extinguish the mark-to-market exposure of the derivative subject to the threshold and minimum transfer amounts applicable to the counterparty."

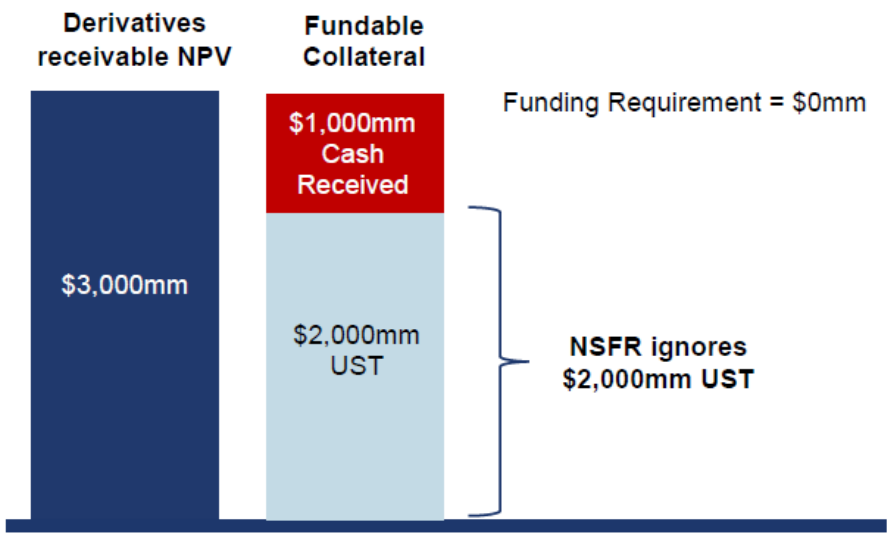
Net Stable Funding Ratio

Derivatives - NSFR Ignores Funding Value of High Quality Securities Collateral Held

Proposal (2): Recognize rehyp HQLA securities collateral where collateral meets regulatory margin standards

- NSFR limits fundable collateral to cash collateral that is nettable under the Basel III leverage ratio calculation (LR)
- As a result, the NSFR disregards high quality collateral received by a bank to reduce its derivative receivables, even when the securities received have cash-like liquidity characteristics (e.g., USTs). This treatment is not in line with the principles of Paragraph 14, which states that asset quality and liquidity value were taken into consideration in determining the appropriate amount of required stable funded for assets
  - For example, Treasuries, which are treated as cash equivalents for LCR purposes, are treated as if they were illiquid assets with no funding value:

Example 1 – Zero threshold CSA



- In contrast, derivatives payable NSFR calculation recognizes that variation margin posted to a derivative liability is a funding drain for both securities and cash collateral
- We believe that the NSFR should give ASF funding credit for high-quality collateral that can be used as a funding source, particularly Level 1 assets, with appropriate haircuts (that are already referenced in the NSFR for those asset types) applied to non-cash collateral when calculating ASF

Net Stable Funding Ratio

Derivatives - NSFR Ignores Funding Value of High Quality Securities Collateral Held

Example: Leverage Ratio netting introduces different RSF requirements for similar risks

- A firm's funding requirement on a derivatives receivable will vary significantly depending on the type of collateral received and collateral management strategy used

Example 2 – Zero threshold CSA

	Scenario 1	Scenario 2	Scenario 3	Scenario 4
Derivative NPV	1,000mm	1,000mm	1,000mm	1,000mm
Collateral[1]	1,000mm USD cash	1,000mm USD cash	1,000mm USTs	1,000mm USTs
Use of Collateral	Invest in 1,000mm UST	Reverse in 1,000mm UST	Leave USTs unencumbered	Repo USTs for Cash with a financial counterparty for <6 months
Implied RSF	**5%**	**10%**	**100%**	**100%**
Balance Sheet Treatment	■ Derivative Receivable on B/S: 0 ■ UST Firm Inventory on B/S: 1,000mm	■ Derivative Receivable on B/S: 0 ■ Reverse Repurchase Agreement (with a financial counterparty) on B/S: 1,000mm	■ Derivative Receivable on B/S: 1,000mm ■ Unencumbered USTs off B/S: 1,000mm	■ Derivative Receivable on B/S: 1,000mm ■ Cash on B/S: 1,000mm ■ Repurchase agreement on B/S: 1,000mm

USTs given no funding value under Leverage Ratio netting in Scenarios 3 & 4

- It is standard collateral management practice to convert cash collateral received into securities to minimize credit risk from cash balances that would be placed at agent banks, resulting in inconsistent RSF factors for similar risk scenarios
  - **Same Portfolio and nearly identical liquidity risk, but very different RSF**

[1] *Examples ignore collateral haircuts*

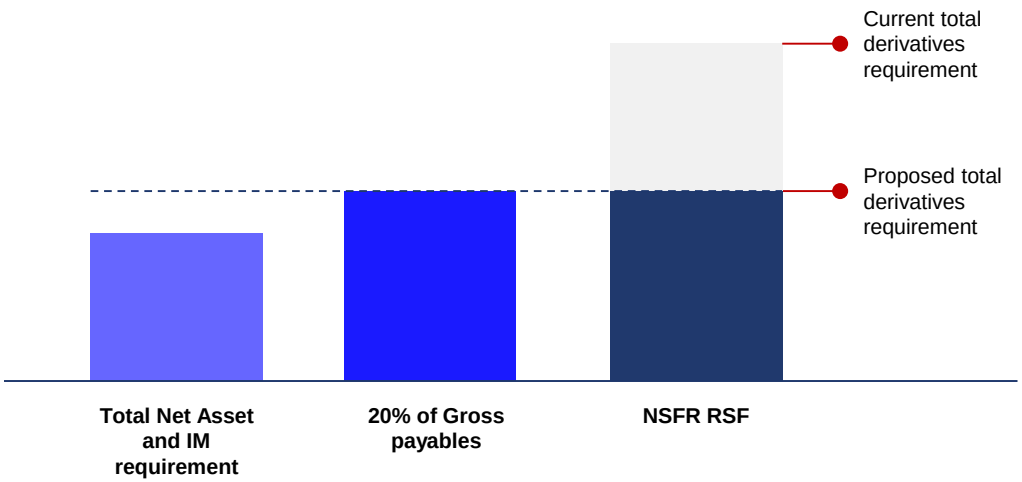
Net Stable Funding Ratio

Derivatives – Volatility add-on should be tied to collateral volatility

Proposal (3): Apply 20% factor as a floor to derivatives RSF instead of an add-on

- Paragraph 43(d) requires an additional stable funding requirement for 20% of derivative liabilities before deducting variation margin posted (i.e., 20% of gross derivative balance sheet liabilities)
- This is the only instance in the NSFR where a firm's balance sheet liability (as opposed to a firm's asset) results in a stable funding requirement
- Contingent liquidity risks related to derivatives MTM movements are already captured by the LCR and are realized through collateral outflows
- The size of a gross payable on a bank's balance sheet is not a good indicator of a firm's market contingent funding requirements as it does not take into account either: (1) the collateral a firm is required to post to secure its derivative liabilities or (2) the rehypothecatable cash and liquid securities collateral a firm receives from other counterparties to secure its derivative assets
- If the intention of the add-on is to ensure a minimum amount of RSF for derivatives, a less biased alternative approach would be to apply the requirement as a floor instead of an add-on
  - Under the floor approach the total derivatives RSF requirement would be the larger of the 20% Payable and the receivable and IM RSF requirements

Example

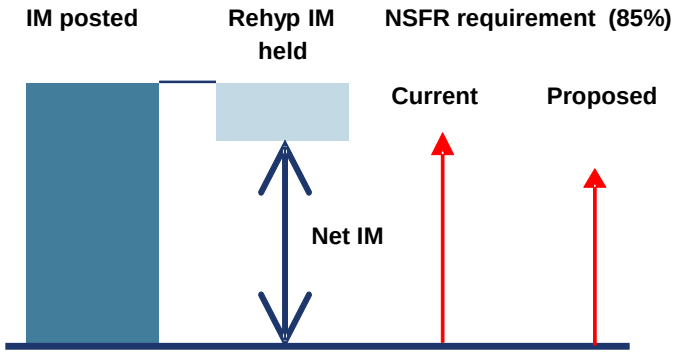


Net Stable Funding Ratio

Derivatives - NSFR Ignores the Funding Value of Rehyp Initial Margin Held

Proposal (4): Allow rehyp IM held to offset IM posted

- NSFR currently prescribes a 85% funding requirement for IM posted but does not assign any funding value to IM received
- Initial Margin held by a covered company where it has contractual and operational capability to monetize the collateral (rehypothecation) creates funding value for the covered company
  - Initial Margin is contractually linked to the derivative and available for use by the covered company for the duration of the derivative contract
  - In many cases IM held and posted are related to the same risk positions and are tenor matched, but are not necessarily part of a "linked transaction"
- The introduction of Basel IOSCO Margining rules is expected to result in structural changes to size, tenor, and composition of Bank's IM requirements; as the market adapts to margining rules it is prudent to re-assess the NSFR requirements for IM in the future to ensure it is appropriate for the new environment
- **Proposal:** Allow rehyp IM to offset IM posted and revisit NSFR requirements after impact of margining rules becomes more clear



Net Stable Funding Ratio

Derivatives – NSFR Carves Out IM from Clearing, But Not Principal Market Making Activity

- Financial institutions can provide market access to clients by
  - (i) Acting as a clearing member facilitating client trading on clearinghouse / exchange, or
  - (ii) Acting as a principal market maker facing the client directly and being responsible for hedging the risk
- NSFR gives preferred funding-neutral treatment to IM posted as a clearing provider (Footnote 18), but not for the case of a principal market maker
  - Footnote 18: *"Initial margin posted on behalf of a customer, where the bank does not guarantee performance of the third party, would be exempt from this requirement."*

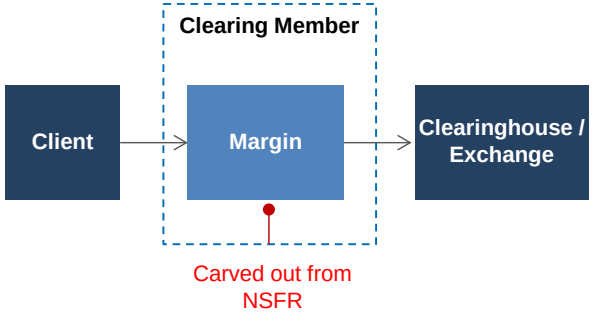
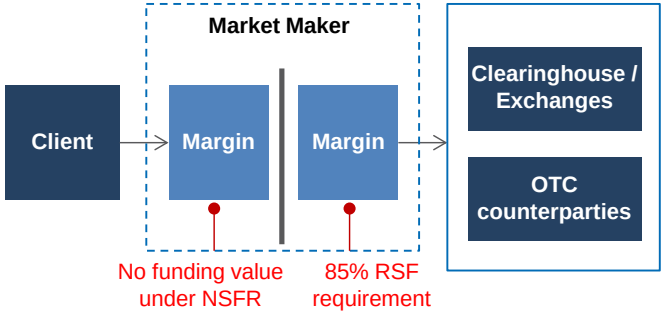
Clearing Member

- Allows a client to trade on an exchange / clearinghouse without being an exchange / clearing member
- Clearing member manages margining with the central counterparty (CCP) on behalf of the client
- Margin calls to the clients depend on the margining requirement of the CCP, however, the clearing agent can call for excess collateral
- Any collateral delivered by the client to the clearing agent can only be used for posting to the CCP
- The clearing member is not responsible for managing the market risk of the client's positions with the CCP

Principal Market Maker

- Faces client directly and re-hedges the risk with other OTC counterparties and/or exchanges / clearinghouses
- Typically will require margin from the client and needs to post margin for hedges, but size of margin calls are not directly linked
- If clients post rehyp initial margin, it can be used to (partially) offset the funding requirement of posting initial margin to central counterparties for executing hedges
- Responsible for market risk management of client trades and may take basis risk between client trades and hedges

Client Clearing As A Service



Market Making Assuming Principal Risk