August 5, 2016

Via Email (regs.comments@occ.treas.gov

Office of the Comptroller of the Currency
400 7th Street, SW, Suite 3E-218
Mail Stop 9W-11
Washington, DC 20219
Attention: Legislative and Regulatory Activities Division
Docket ID OCC—2104—0029; RIN 1557—AD97

Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551
Attention: Robert deV. Frierson, Secretary
Docket No. R—1537; RIN 7100 AE-51

Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429
Attention: Robert E. Feldman, Executive Secretary
RIN 3064—AE 44

Re: SIFMA AMG and MFA Comment on Proposed Net Stable Funding Ratio Requirement

Dear Sirs and Madams:

The Asset Management Group of the Securities Industry and Financial Markets Association ("SIFMA AMG" or "AMG") and Managed Funds Association ("MFA")[1] appreciate the opportunity to comment on the proposed rule (the "Proposal") issued by the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency (the "Agencies") to establish a Net Stable Funding Ratio ("NSFR") requirement for large banking organizations.[2]

Securities and derivatives products and services offered by banking organizations are central to our members' investment and risk-management strategies. A host of new capital and liquidity regulations that the Agencies have introduced in the last several years, including Basel III risk-based capital requirements, the Supplementary Leverage Ratio ("SLR"), and the Liquidity Coverage Ratio

1 *See* Annex A for descriptions of SIFMA AMG and MFA.

2 81 Fed. Reg. 35,124 (June 1, 2016).

("LCR"), have resulted in higher costs (with costs expected to increase further) for directional market participants, like pension funds and mutual funds, due to the dramatic increase in capital and liquidity requirements for banking organizations with which asset managers transact on behalf of their clients.[3] Other new requirements, including the Enhanced Supplementary Leverage Ratio, the surcharge for Global-Systemically Important Banks, Total Loss Absorbing Capacity requirement, Long-Term Debt requirement, Single Counterparty Credit Limits, and capital and liquidity stress testing, are based on many of the same concepts as risk-based capital requirements, the SLR, and the LCR, and will only further increase costs for asset managers' clients. Finally, mandatory clearing requirements and margin requirements have fundamentally transformed the derivatives markets, reduced risks to banking organizations arising out of derivatives, and imposed heightened requirements for banking organizations' clients such as our members to access the derivatives markets to hedge risks.

We believe that these regulations, in combination and, in some respects, in isolation, are not proportionate to the leverage, liquidity and capital risks carried by the transactions. The regulations have addressed a broad spectrum of risks to banking organizations arising out of securities and derivatives activities that have made these organizations safer. But the regulations have also made it more difficult and costly for banking organizations to offer these products and services to their clients, resulting in higher costs, decreased liquidity, and reduced access for financial products' end users like our members and their clients.[4]

In this context, and for the reasons set forth below, we have serious concerns that the NSFR Proposal would produce very little additional prudential benefits beyond those resulting from the many new regulations adopted since the financial crisis, while at the same time it could impose material costs that will be imposed upon our members' clients – ultimately to the detriment of retirement savers, retail investors, corporations, and consumers. We therefore urge the Agencies to take into account the cumulative negative impacts of their rules, in addition to their benefits, before adding an NSFR requirement that could result in higher costs and reduced market liquidity with very little additional prudential benefit.

In addition, some of the most potentially negative aspects of the Proposal were introduced by the Basel Committee in the final international standard without ever having been made available for public comment. For these aspects of the Proposal in particular, the Agencies should be much more receptive to suggested changes from commenters than would otherwise be the case so that, as the Administrative Procedure Act contemplates, the public is accorded a true opportunity to participate in the rulemaking process.

For the reasons discussed below, if the Agencies proceed to finalize the NSFR, they should only do so after making significant changes. Section I describes our members' concerns and suggestions relating to the Proposal's treatment of derivatives; Section II discusses non-derivatives

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3 For instance, a recent AMG member survey found that as a result of the SLR, a substantial number of AMG members have been asked to pay higher clearing fees to a clearing firm or to reroute trade execution business to a clearing firm to offset higher fees. *See* SIFMA AMG, Letter to Mr. William Coen, Secretary General, Basel Committee on Banking Supervision (June 30, 2016), *available at* http://www.sifma.org/issues/item.aspx?id=8589961201.

4 *Id.*

issues; and Section III summarizes our recommendations to modify the Proposal before it becomes final.

I. The NSFR Proposal Would Impose Unnecessary Burdens upon Derivatives Transactions

We are concerned that, as proposed, the NSFR Proposal would cause end users like our members and their clients to bear the costs of incremental long-term funding required to support derivatives in a manner disproportionate to their actual funding requirements. Based on conversations our members have had with bank-affiliated dealers and FCMs, banking organizations expect to be required to raise significant amounts of costly long-term funding to support bilateral derivatives under the Proposal. For instance, an Oliver Wyman study has projected that the NSFR, as finalized at the Basel level, would require global banking organizations to raise approximately $500 billion of additional long-term funding to support existing bilateral derivatives activities.[5] According to this study, because long-term funding is more expensive than short-term funding by approximately 150-200 basis points, industry costs would increase approximately $5-8 billion in the aggregate as a result of the NSFR's treatment of derivatives. As our members have unfortunately experienced with other recent regulations introduced by the Agencies, the increased costs of complying with the NSFR are likely to strongly incentivize banking organizations to (a) pass along their costs to end users, and (b) cease entering into derivatives with end users.

This section describes several ways that the Proposal's treatment of derivatives should be amended to improve the NSFR and to avoid imposing unnecessary barriers on end users seeking to access derivatives to hedge risk or creating adverse consequences for important markets.

A. The Asymmetrical Treatment of Variation Margin Received and Variation Margin Provided is Unfounded

The Proposal would provide that all variation margin provided by a banking organization to its counterparty, no matter its form, currency, amount, or frequency of delivery, would reduce the banking organization's derivatives liability amounts. Implicitly, this treatment recognizes that all variation margin reduces the banking organization's obligation to its counterparty. Yet, the Proposal would not allow variation margin received by a banking organization to reduce the banking organization's derivative asset amounts unless the margin satisfies criteria for recognition in the SLR. These criteria include that variation margin: (1) is in the form of cash, (2) is in the same currency as the settlement currency, and (3) is the full amount necessary to fully extinguish the net current credit exposure to the counterparty of the derivative. In other words, the Proposal assumes that variation margin reduces the counterparty's obligation to the banking organization in only certain specific circumstances.

We do not believe such asymmetry is necessary or appropriate in the context of the NSFR. While the Basel Committee included no explanation for the asymmetry when introducing it for the first time in the final international standard, the Proposal explains that the asymmetry is intended to prevent "understatement of the covered company's derivatives RSF amount." As we understand it,

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5 *See* Oliver Wyman, Impact of NSFR on Capital Markets: Considerations for Implementation, at 16 (January 2015).

this means that the asymmetry is intended to serve as a type of regulatory buffer. However, it is not appropriate to include such a buffer in the calculation of derivative asset amounts because (1) the NSFR, unlike the LCR, is not a stressed measure, (2) banking organizations will already maintain buffers of available stable funding ("ASF") above the regulatory minimum amount in order to accommodate fluctuations in required stable funding ("RSF") that may occur in the future, and (3) the Proposal already includes an RSF buffer for derivatives' liquidity risk in the form of an add-on equaling 20 percent of a banking organization's gross derivatives liabilities, which we discuss below.

While we believe that ***any*** asymmetry in the treatment of variation margin is unjustified, several of the criteria for recognizing variation margin in the SLR are particularly ill-suited to play a similar role in the NSFR. The Agencies introduced these strict criteria in the SLR for a specific reason: because the SLR "generally does not permit banking organizations to use collateral to reduce exposures for purposes of calculating leverage exposure" the strict criteria would ensure that the variation margin could be characterized not as collateral, but as "in substance, a form of pre-settlement payment."[6] This reason simply is not applicable in the context of the NSFR; the NSFR ***does*** recognize collateral as reducing funding risks and funding obligations. And if not amended in the context of the NSFR, several of the criteria would be fundamentally inconsistent with the Agencies' new margin rules for uncleared swaps, the LCR, and other parts of the proposed NSFR. We discuss address each such criterion below.

1. Cash Requirement

We see no reason why all non-cash collateral should be excluded from reducing a banking organization's derivative asset amounts. When finalizing margin rules for uncleared swaps, the Agencies explicitly recognized that securities are an "appropriate" form of collateral for derivatives with financial end users, and accordingly the rules permit banking organizations to receive variation margin in the form of securities from end users to satisfy margin requirements.[7] The NSFR Proposal does not include any explanation for why securities are appropriate collateral for margin purposes but would be inappropriate collateral for NSFR purposes. And while the margin rules ostensibly permit the use of securities variation margin, the Proposal would strongly incentivize banking organizations to impose a fee on counterparties for the use of securities variation margin to offset the increased cost of funding derivatives backed by such collateral. This result would entirely undermine the policy choice the Agencies made in the margin rules to permit the use of securities variation margin, and would needlessly adversely affect end users.

As the margin rules come into effect, many end users will be required to post variation margin for the first time for certain products, and are likely to do so by posting securities. For instance, many pension funds have not historically been required to post variation margin with respect to uncleared foreign exchange swaps ("FX") they enter into to hedge their currency risks, but will be required to do so under the margin rules. Due to large transaction volumes and their cash management strategies, pension funds will find it very difficult to post cash variation margin for FX; instead, pension funds will be much more able to post U.S. Treasuries or other liquid debt

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6 79 Fed. Reg. 57,725, 57,730 (Sept. 26, 2014).

7 80 Fed. Reg. 74,840, 74,866 (Nov. 30, 2015); *see also* the Agencies' margin rules § _.6(b) (permitting the receipt of non-cash variation margin from financial end users).

securities. As a result, FX with pension funds would be highly disadvantaged transactions under the NSFR unless the Proposal were amended to recognize non-cash variation margin.

End users such as mutual funds and pension funds may post margin to a banking organization in the form of highly liquid securities not only because it may be more efficient for the funds to do so, but also because margin pledged to the banking organization is often segregated at a custodian bank pursuant to a tri-party arrangement. Non-cash collateral generally is not consolidated on the balance sheet of the custodian bank, and therefore would be bankruptcy remote in the event of insolvency of the custodian bank, whereas cash on deposit at the custodian bank generally is a balance sheet liability of the bank. The use of non-cash collateral thus mitigates the end user's exposure to an insolvency of the custodian bank.

Moreover, several types of securities – including those categorized as High Quality Liquid Assets ("HQLA") under the LCR – are plainly highly liquid sources of funds, as the Agencies have recognized in the LCR and in the NSFR Proposal itself. For instance, the funding value of a security that is a Level 1 HQLA is not discounted at all under the LCR.[8] And in the preamble to the Proposal, the Agencies recognized that securities that are HQLA have "high credit quality and favorable market liquidity characteristics, which reflect their ability to serve as reliable sources of liquidity."[9] As such, the proposed NSFR would assign a lower RSF factor to assets when they are collateralized by Level 1 HQLA securities. For instance, the use of Level 1 HQLA to collateralize secured lending transactions with a financial sector entity that mature within six months could result in such lending transactions receiving a 10 percent RSF factor rather than the 15 percent RSF factor that would be applied using other forms of collateral – a 33 percent reduction. Additionally, a Level 1 HQLA held on balance sheet would receive a 5 percent RSF factor compared with a 15 percent RSF factor for Level 2A HQLA and a 50 percent RSF factor for Level 2B HQLA. At the very least, the funding value of these types of securities should be recognized in the NSFR when calculating derivative asset amounts.

2. Same Currency Requirement

The Proposal does not explain why variation margin denominated in a different currency than the currency of settlement should not be eligible to reduce a banking organization's derivative asset amounts. In fact, there are many reasons to treat variation margin denominated in a currency other than the settlement currency as reducing a banking organization's funding requirements.

For clients engaged in transactions in markets around the world, posting variation margin in numerous currencies can be cumbersome, requiring clients to enter into a great number of individual spot FX transactions to meet unknown future margin requirements. Thus, as a service to their clients, banking organizations sometimes agree to allow clients to post variation margin in a currency that is different than the currency of settlement. This practice can promote simplicity and certainty for both counterparties. However, the NSFR Proposal threatens this practice. Banking organizations would be much less inclined to offer this service if it would result in significantly

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8 LCR § _.21(b)(1).

9 81 Fed. Reg. at 35,142.

higher RSF charges as a result of the SLR criterion. The NSFR should not be structured to disrupt this sensible market practice unnecessarily.

In every other part of the NSFR framework, the Proposal would treat collateral the same whether it were denominated in a different currency than the asset or in the same currency as the asset. At the same time, the LCR includes foreign withdrawable reserves as Level 1 HQLA because, in the Agencies' words, foreign reserves "should be able to serve as a medium of exchange in the currency of the country where they are held."[10] In addition, the LCR classifies publicly traded equities issued in a currency of a jurisdiction in which the banking organization operates as HQLA.[11] Similarly, the Agencies' margin rules and risk-based capital permit uncleared swaps to be collateralized by assets denominated in a currency other than the settlement currency.[12] The Agencies have implicitly recognized in each of these other contexts that collateral offers funding value irrespective of its currency of denomination. In light of this substantial precedent for recognizing a multitude of currencies, the NSFR should not disregard the funding value of variation margin posted in a different currency than the currency of settlement.

3. Full Amount Requirement

The Proposal also does not explain why variation margin would need to be the "full amount that is necessary to fully extinguish the net current credit exposure to the counterparty of the derivative contracts" to reduce a banking organization's derivative asset amounts. It makes no sense for the NSFR to disregard entirely any amounts of variation margin received in partial satisfaction of the banking organization's derivative asset. Whether variation margin received by the banking organization fully extinguishes its current exposure has no bearing on whether the amount actually received reduces the banking organization's asset amount and funding risk. Variation margin of any amount is valid as a source of funding for the banking organization. Finally, because of daily margin requirements and enforceable netting agreements, any liquidity risk to the banking organization arising out of derivatives that are temporarily undermargined would be limited to the amount of intraday margin shortfalls, which in all events would not be recognized as reducing derivative asset amounts under the NSFR.

B. The NSFR Should Take Into Account the Tenor of Derivative Assets

In the preamble to the Proposal, the Agencies state that "[a]ssets with a shorter tenor . . . would require a smaller amount of stable funding under the proposed rule because a covered company would have access to the inflows under these assets sooner. Thus, the proposed rule would generally require less stable funding for shorter-term assets compared to longer-term assets."[13] Yet, when it comes to derivatives, the Proposal would not follow the logic of the rest of the NSFR: all derivative assets would require the same amount of funding whether a banking organization would have access to the inflows under those assets soon or over a longer period of time.

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10 79 Fed. Reg. 61,440, 61,456 (Oct. 10, 2014).

11 LCR § _.20(c)(ii)(2).

12 Margin rules § _.6(b), risk-based capital rules § _.37(c).

13 81 Fed. Reg. at 35,140.

Consistent with the rest of the NSFR, downward adjustments in RSF factors would be appropriate for derivative assets maturing in one year or less or six months or less from the time of calculation. A banking organization will receive the inflows associated with such assets sooner than the inflows associated with longer-term derivative assets. While the Agencies do not explain in the Proposal why they do not propose such an adjustment, we understand that the Agencies may be concerned that banking organizations would seek to roll over derivatives transactions that are set to mature shortly in order to maintain their relationships with counterparties, rather than receive the inflow amounts. (The Agencies make a similar assumption with respect to loans to wholesale, nonfinancial borrowers,[14] yet the Proposal would still provide a downward adjustment for short-dated loans to wholesale, nonfinancial borrowers compared to longer-term loans to such borrowers.) We do not believe such a concern is warranted for uncleared derivatives with financial sector entities like our members and their clients, which banking organizations can and frequently do decide not to roll over. Derivatives should not be singled out for more punitive treatment than other assets without the Agencies providing a clear and data-driven basis for such a distinction.

C. The 20 Percent Add-On for Gross Derivatives Liabilities is Seriously Flawed, Procedurally Unjustified, and Should Be Re-Proposed Along With the Release of More Information

When finalizing the international NSFR standard, the Basel Committee inserted an RSF add-on equaling 20 percent of a banking organization's gross derivative liabilities – without seeking public comment on such an add-on and without providing any commentary or explanation for it. In the Proposal, however, the Agencies explain that the add-on is intended to capture the liquidity risk associated with potential changes in the value of a banking organization's derivative transactions and the concomitant need for the banking organization to post more variation margin to its counterparties.

There are many reasons to doubt that the proposed add-on bears a reasonable relationship to this risk. First, the add-on would apply equally to all types of derivatives, regardless of whether the reference asset is lower-volatility or higher-volatility. Lower-volatility derivatives clearly present less liquidity risk because they are less likely to shift in price and thereby require the banking organization to post more variation margin. Likewise, the add-on would not reflect the fact that derivatives with a short remaining maturity present less opportunity for prices to move against the banking organization than derivatives with a longer remaining maturity.

Second, we are not aware of any correlation between a banking organization's gross derivatives liability amount – which only reflects the degree to which prices ***have*** moved against the banking organization since the derivative came on the banking organization's balance sheet – and the likelihood of prices ***continuing to move*** against the banking organization. It is possible that gross liability values instead reflect the opposite correlation – that the more prices have moved

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[14] *See* 81 Fed. Reg. at 35,140 ("[C]overed companies often consider their lending relationships with a wholesale, nonfinancial borrower to be important to maintain current business and generate additional business in the future. As a result, a covered company may have concerns about damaging future business prospects if it declines to roll over lending to such a customer for reasons other than a change in the financial condition of the borrower.").

against the banking organization, the more likely it is that prices will move back in the banking organization's favor.

Third, unmargined derivatives (*i.e.*, those that are exempt from the Agencies' margin rules and that do not otherwise require the exchange of variation margin) present no risk of the banking organization being required to post variation margin because, by definition, the banking organization has no such obligation. Yet, the gross liabilities associated with unmargined derivatives would still be counted under the Proposal.

Fourth, the add-on includes no exception for back-to-back derivatives transactions that a banking organization may enter into to manage its liquidity risks. When a banking organization enters into two equal and offsetting derivatives, it has no contingent funding risk for posting variation margin to its counterparties for those derivatives. If the banking organization is required to post variation margin on one leg of the transactions, it will receive the same amount of variation margin on the other leg.

Fifth, gross derivatives liability values tend to be larger the longer a derivative has been outstanding, simply because there has been more opportunity for prices to move since the inception of the transaction. The proposed add-on would therefore disincentivize banking organizations from entering into and maintaining longer-dated derivatives, which tend to be the derivatives that clients use for hedging purposes. Such a disincentive would result despite the fact that the lapsed duration of a derivative has no relationship to the contingent funding risk of that derivative.

Sixth, the add-on could treat transactions that present identical funding risk as though they present different degrees of funding risk. To illustrate, suppose that a banking organization entered into a one-year interest rate swap, and that six months later, the banking organization were "out of the money" on the swap on a gross basis by $10, but had posted cash variation margin of $10, bringing its current funding obligation to zero. Suppose that at that time (six months after entering into the one-year swap), the banking organization entered into a six-month interest rate swap on the same terms. At that moment, the banking organization would have identical contingent funding risk on the first swap and the second swap, which would have the same remaining maturity and would be based on the same underlying, such that any further move in underlying prices away from the banking organization would create equal obligations to post more variation margin on both swaps. Yet, the banking organization would be required to recognize an RSF add-on of $2 (20 percent of $10) on the first swap and an RSF add-on of $0 on the second swap as if the contracts entailed different risks of posting variation margin. This artificial difference in RSF would be based solely on the fact that the banking organization entered into the transactions at different times (and therefore, that the gross liability amounts of the transactions would be different), and would persist throughout the remaining maturity of the contracts.

Seventh, the add-on could be pro-cyclical. Derivatives gross assets and derivatives gross liabilities both tend to increase in times of volatility as prices move in greater increments. In the aggregate, these price movements may not actually present increased funding risk to a banking organization that has a well balanced book of derivatives. Yet, the use of gross derivative liability values in the add-on would require banking organizations to raise more stable funding during the period of volatility. Banking organizations might respond by selling assets and/or closing out derivative positions, which could increase systemic risk.

Finally, without more empirical support that is disclosed for public comment, the 20 percent calibration on its face is arbitrary. The Agencies state that public and supervisory information on the volatility of derivatives assets and liabilities demonstrates that "[t]he proposed 20 percent factor falls within the range of observed volatility when measured relative to derivatives liabilities excluding collateral received or provided."[15] Yet, the Agencies have not released any underlying data or even the most basic information about it. In doing so, the Agencies deprive the public of the ability to provide meaningful comment:

- Without knowing what types of derivatives the data covers, the public does not know whether the 20 percent calibration is accurate for both lower-volatility derivatives and higher-volatility derivatives;

- Without knowing *where* within the range of observed volatility the 20 percent factor falls, the public does not know whether the 20 percent factor is overly conservative, nor the extent to which different add-on factors would fall more squarely in the range of observed volatility;

- Without knowing what period the data covers, the public does not know whether the data are representative of a full economic cycle; and

- Without knowing the number and the identities of the banking organizations represented in the data, the public does not know whether the data are representative of the broader derivatives market.

As a result, it is nearly impossible for us to offer meaningful comment on whether the proposed add-on is correctly calibrated – or whether the two alternatives provided in the preamble to the Proposal would be any better.[16]

Accordingly, we urge the Agencies to take two steps before deciding whether to adopt an add-on, and if so, deciding how that add-on should be calibrated. First, the Agencies should release the data supporting the proposed add-on so that the public can examine the reasonableness of the proposed approach as well as possible alternatives. Second, the Agencies should explain how the proposed add-on bears a reasonable relationship to the risk of a banking organization being required to post more variation margin, in light of the reasons we discuss above that suggest no such relationship exists. We do not believe the Agencies would be justified – procedurally or substantively – in finalizing any add-on without first taking these steps.

D. At a Minimum, the Add-On Should Not Gross Up Settlement Payments

Finally, in addition to our other reasons for opposing the add-on, we note that it would inexplicably calculate gross derivative liabilities without taking into account ***settlement*** payments received that would plainly reduce the legal amount of such liabilities. In contrast, the add-on included in the Basel Committee's NSFR standard does not require a gross-up for settlement

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15 81 Fed. Reg. at 35,153.

16 The Agencies seek public comment on whether it would be better to base the add-on on a historical look-back period, modeled estimates of potential future exposure, or some other measure.

payments. This "gold-plating" of the Basel standard would needlessly raise funding costs for banking organizations for derivative transactions that include settlement payments, when in fact the NSFR should be designed to incentivize the use of settlement payments to extinguish banking organizations' obligations to their counterparties.

II. The NSFR Proposal Would Imposes Unnecessary Costs Upon Securities Financing Transactions

Our members rely on the repurchase agreement ("repo") and securities lending markets to facilitate transactions for their clients in the equity and bond markets and to deliver access to capital markets with low transaction costs that allow these end-users to achieve their investment objectives. As the Financial Stability Board has observed, liquid securities financing markets are critical to the functioning of cash, bond, securitization, and derivatives markets.[17] Securities financing transactions are also deeply connected to a significant portion of transactions that occur in the bond and equity markets. For example, they (a) provide banks and broker-dealers with the ability to quote two-way prices (*i.e.*, to make markets) in reasonable size and without carrying inventory in every security (in itself a significant risk-management consideration); (b) allow all participants to finance positions; (c) are critical in avoiding settlement delivery failure; and (d) provide the ability to hedge against credit- or market-risk exposures arising from other business activities, such as participating in government bond auctions, underwriting corporate bonds, and trading in cash instruments and derivatives.

In this context, we are concerned that the Proposal's treatment of repo and client short transactions would disincentivize banking organizations from entering into these transactions with our members and their clients, potentially with the effect of impairing the functioning of the capital markets. We also have concerns about the Proposal's treatment of client segregated assets that arise out of a variety of capital markets transactions.

A. The NSFR Should Treat Repos and Reverse Repos Symmetrically

As it would with variation margin, the Proposal would treat repos and reverse repos with financial sector entities asymmetrically. Our members and their clients are financial sector entities, which include any investment advisor, investment company, pension fund, or non-regulated fund. Under the Proposal, short-term borrowing by a banking organization from a financial sector entity would be assigned a 0 percent ASF factor, whereas short-term lending by a banking organization to a financial sector entity would be assigned a 10 percent or 15 percent RSF factor, depending on the quality of the collateral received and whether the banking organization has the right to re-

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17 *See* Financial Stability Board, Securities Lending and Repos: Market Overview and Financial Stability Issues (Apr. 2012), available at http://www.financialstabilityboard.org/publications/r_120427.pdf. Similarly, the Bank of England's Financial Policy Committee has found that "Repo markets also support market functioning. For example, they allow prompt borrowing of securities to prevent settlement fails, and are commonly used to raise cash for use as margin in derivatives transactions. In stressed conditions, repo markets offer banks a route to convert their holdings of liquid assets into cash. If banks are unable to access the repo market they may be forced to sell liquid assets, which could exacerbate stress. Selling assets outright may also incur losses from the unwinding of interest rate hedges." Bank of England, Financial Stability Report, at 29 (July 2016), available at http://www.bankofengland.co.uk/publications/Pages/fsr/2016/jul.aspx.

hypothecate the collateral. Stated differently, the Proposal assumes that banking organizations would be more likely to roll over short term loans to financial sector entities than such entities would be likely to roll over short term loans to banking organizations.[18] While we agree that this assumption is plausible with respect to banking organizations' loans to non-financial borrowers, it is much less likely to be the case for borrowers that are financial sector entities.

We also think that applying a blanket asymmetrical treatment across reverse repos is likely to adversely affect the capital markets in several ways. For instance:

- Repos are generally a high volume and low margin business for banking organizations, and thus incremental funding costs to support repos would greatly decrease banking organizations' incentives to participate in repo markets.

- Decreased incentives for banking organizations to enter into repos would reduce the liquidity of the markets for government and corporate bonds underlying repos. The market for government bonds would be impacted most, as the majority of repo transactions use government bonds as collateral.

- As banking organizations' costs of borrowing bonds increase because term financing would be required in order to meet the banking organization's RSF requirement, market-making to support primary dealerships may be reduced. As a result, the bond market could be significantly disrupted.

In sum, the Proposal's treatment of repo and reverse repo is likely to reduce liquidity in the capital markets, leading to higher borrowing costs and increased transactions costs. These costs will ultimately be borne by consumers and retail investors in the funds and accounts managed by our members. We believe that these potential impacts on the repo markets, as well as the potential effects such market impacts would have on end-users, should be considered before finalizing the NSFR.

Finally, as it decides whether to impose the asymmetrical treatment of repos and reverse repos in the NSFR context, the Agencies should take into account the effect of their other regulations on banking organizations' management of risks arising from such instruments. For instance, the SLR does not risk weight a banking organization's assets, meaning that a banking organization holding reverse repos funded with low-risk assets such as U.S. Treasuries must nonetheless maintain significant amounts of capital against these reverse repos. As another example, the Method 2 G-SIB Surcharge calculation requires a higher capital surcharge the more a banking organization relies on short-term wholesale funding such as repos. We submit that these other regulations render unnecessary the asymmetry of the Proposal.

B. The NSFR Proposal Should Recognize the Interdependence of Assets and Liabilities in Client Short Transactions

[18] 81 Fed. Reg. at 35,140 ("A covered company may face pressure to roll over some portion of its assets in order to maintain its franchise value with customers and because a failure to roll over such assets could be perceived by market participants as an indicator of financial distress at the covered company.").

Paragraph 45 of the Basel Committee's NSFR standard recognizes that asset and liabilities arising from certain transactions are "interdependent" such that: the liability cannot fall due while the asset remains on the balance sheet; the principal payment flows from the asset cannot be used for something other than repaying the liability; and the liability cannot be used to fund other assets. For such transactions, national supervisors may adjust the RSF and ASF factors for related assets and liabilities so that they are both 0 percent, provided that the transactions satisfy certain criteria and no "perverse or unintended consequences" would be created.

Notwithstanding the intent of the Basel Committee for member jurisdictions to recognize certain transactions as creating interdependent assets and liabilities, the Proposal would not recognize any such transactions in the United States. However, we firmly believe banking organizations' assets and liabilities arising out of client short transactions that our members and their clients enter into as part of their investment strategies can fit squarely within the Paragraph 45 criteria.

When a banking organization obtains securities from a securities lender to effect a client short transaction for its client, the banking organization receives short sale proceeds from the client's sale of the borrowed security, creating a liability, and at the same time, the banking organization provides collateral to the securities lender for the securities borrow transaction, creating an asset. To then close out the client's short transaction, the client delivers the borrowed security to the banking organization in order for the banking organization to provide the short sale proceeds to the client, which closes out the banking organization's liability. At the same time, the banking organization returns the security to the lender and receives the cash collateral back from the securities lender, closing out the asset.

The asset and liability arising from this transaction are "interdependent" when the transaction is subject to Regulation T because Regulation T generally permits broker-dealers to borrow securities only for the purpose of making delivery of the securities or other similar circumstances.[19] As a result of Regulation T: (1) contractual provisions of a banking organization's broker-dealer subsidiary (which are subject to Regulation T) ensure that the banking organization can only create the asset where there is a supporting liability due to a client transaction; (2) the banking organization can only *maintain* the asset for as long as the liability is outstanding; and (3) the banking organization will therefore close out the asset and liability at the same time, with the result that the effective maturity of the asset and liability are the same. To the extent there are any differences between the principal amounts of the asset and liability because of securities lenders' requirements to overcollateralize securities borrowing transactions, the Agencies could limit recognition of interdependent status to the amount of the asset or liability, whichever is lower. Finally, we do not believe any "perverse or unintended consequences" would result from the NSFR recognizing the interdependent nature of the asset and liability in these circumstances, and the Agencies have not identified any such consequences in the Proposal. Therefore, we believe that, in these circumstances, the assets and liabilities arising out of client shorts should receive ASF and RSF factors of 0 percent.

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[19] 12 C.F.R. § 220.10.

C. Segregated Client Assets Do Not Require Funding As Though They Were Banking Organizations' Proprietary Assets

For a client asset held in a segregated account, the Proposal would assign the asset the RSF factor that would be assigned to the asset if it were not held in a segregated account. Thus, for instance, the Proposal would assign a 15 percent RSF factor to a client's cash placed on deposit with a third-party insured depository institution as if the banking organization had made a short-term unsecured wholesale loan to a financial sector entity, and would assign a 5 percent RSF factor to a client's U.S. Treasury securities held by the banking organization in a segregated account pursuant to applicable customer protection requirements.

Segregated client assets can arise on a banking organization's balance sheet in connection with a variety of custodial, investment, and hedging transactions, and it is important to our members that banking organizations are not penalized or disincentivized from maintaining client property pursuant to applicable segregation regimes. Strict Securities and Exchange Commission ("SEC") rules provide that broker-dealers cannot raise more money using client securities than they lend to their clients.[20] In addition, the rules require broker-dealers to maintain possession or control of their customers' fully paid and excess margin securities, to the extent that those excess margin securities exceed 140 percent of the customer's debit balance. These funds must be deposited into a special reserve bank account, segregated from the broker-dealers' proprietary holdings, for the benefit of the customers. Similarly, strict Commodity Futures Trading Commission ("CFTC") rules that apply to futures commission merchants ("FCMs") ensure that (1) client property is held separately from, and accounted separately from, the FCM's own assets or assets under management; (2) client property is "bankruptcy remote" from the FCM's assets, so that, if the FCM were to fail its creditors would have no rights to the property; and (3) client property instead must be held only in cash or other highly conservative, highly liquid investments such as U.S. Treasury securities so that it can quickly be monetized and returned to the client.[21]

In effect, these segregation regimes ensure that segregated assets remain client property and are not freely used by a broker-dealer or FCM for its own purposes. To the extent that a client seeks to reduce its investment or trading and withdraw funds, the broker-dealer or FCM simply returns the segregated assets to the client – with the result that the assets fund the outflows and do not require long-term funding support from the banking organization as they would if the assets were used by the banking organization. In this way, segregated client assets are similar to vault cash, to which the Proposal would assign a 0 percent RSF factor.[22]

We believe perverse unintended consequences would result from the NSFR failing to assign an RSF factor other than 0 percent to segregated client assets.[23] For instance, under the Proposal, banking organizations would be incentivized to maintain segregated client balances in non-cash form (such as in U.S. Treasuries, which would receive a 5 percent RSF factor), rather than as cash on

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[20] 17 C.F.R. § 240.15c3-3.

[21] 17 C.F.R. §§ 1.20 et seq.

[22] *See* proposed rule text at § _.106(a)(1)(i).

[23] A 0 percent RSF is warranted only for client assets, not assets contributed by a banking organization to a client account that are not due to the client.

deposit with an unaffiliated depository institution (which would receive a 15 percent RSF factor, because a deposit issued to a banking organization would be considered a short-term unsecured wholesale lending transaction with a financial sector entity). While both types of assets are highly liquid, U.S. Treasuries would need to be liquidated before providing cash to the client, while cash would not. In addition, the Proposal's treatment of segregated assets could cause banking organizations to raise prices for maintaining segregated assets, or even to tell their clients to seek services elsewhere. This is not mere speculation. It has been widely reported that the LCR has had similar effects on banking organizations' willingness to issue client deposits, with some banking organizations beginning to charge large depositors new fees, and some refusing to issue additional deposits to clients.[24]

III. Summary of AMG's and MFA's Recommendations

For the reasons described above, the Agencies should make the following changes to improve the Proposal:

- ***Tailor the Criteria for Recognition of Variation Margin to the NSFR Context.*** The final NSFR should address the Proposal's unnecessary and unjustified asymmetrical treatment of variation margin received and variation margin provided by (1) permitting variation margin in the form of securities that are HQLA to reduce a banking organization's derivative asset amounts, (2) permitting variation margin denominated in any currency of a jurisdiction in which the banking organization operates to reduce derivative asset amounts, and (3) permitting variation margin to reduce derivative asset amounts even if it is not the full amount necessary to extinguish the banking organization's current exposure.

- ***Provide a Downward Adjustment to the RSF Factors of Derivatives With a Short Remaining Maturity.*** Consistent with other parts of the NSFR, the final NSFR should recognize that short-dated derivative assets require less stable funding by including downward adjustments for derivatives with a remaining maturity of one year or less and six months or less.

- ***Release More Information Relating to the Add-On for Potential Portfolio Valuation Changes and Re-propose the Add-On.*** The Agencies should release their data supporting the proposed add-on, explain how the add-on bears a reasonable relationship to the risk it seeks to capture, and only after taking those steps, re-propose the add-on for more meaningful public comment. At the very least, the final U.S. NSFR should not gold-plate the Basel NSFR standard by grossing up settlement payments that extinguish a banking organization's obligation to its counterparty for purpose of calculating the add-on.

- ***Treat Repo and Reverse Repo Symmetrically.*** The Agencies should assign the same percentage factors to the ASF of repos and the RSF for reverse repos for financial sector entity counterparties so as not to disincentivize matched book funding and disrupt the

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[24] *See, e.g.*, Banks Urge Clients to Take Cash Elsewhere, Wall Street Journal (Dec. 7, 2014), available at http://www.wsj.com/articles/banks-urge-big-customers-to-take-cash-elsewhere-or-be-slapped-with-fees-1418003852.

functioning of capital markets transactions that depend on banking organizations to provide repo funding.

- ***Recognize Assets and Liabilities Associated With Client Shorts as Interdependent Assets and Liabilities Requiring 0 Percent RSF or ASF.*** The Agencies should use the discretion permitted to them under Paragraph 45 of the Basel standard to assign a 0 percent RSF to assets arising out of client short transactions when the banking organization's role in the securities borrowing transaction is subject to Regulation T.

- ***Assign a 0 Percent RSF Factor to Segregated Client Assets.*** The final NSFR standard should treat client assets subject to strict SEC or CFTC segregation requirements as the client's property, requiring no stable funding by the banking organization.

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We appreciate the Agencies' consideration of our concerns. Should you have any questions, please do not hesitate to contact AMG at Tim Cameron at (202) 962-7447 or tcameron@sifma.org or Laura Martin at (212) 313-1176 or lmartin@sifma.org, AMG's counsel at Covington & Burling LLP, John C. Dugan at (202) 662-5051 or jdugan@cov.com or Randy Benjenk at (202) 662-5041 or rbenjenk@cov.com, or MFA at Stuart Kaswell or Benjamin Allensworth at (202) 730-2600 or at skaswell@managedfunds.org or ballensworth@managedfunds.org, respectively.

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Annex A

Descriptions of SIFMA AMG and MFA

SIFMA AMG's members represent U.S. asset management firms whose combined global assets under management exceed $34 trillion. The clients of SIFMA AMG member firms include, among others, tens of millions of individual investors, registered investment companies, endowments, public and private pension funds, UCITS and private funds such as hedge funds and private equity funds.

MFA represents the global alternative investment industry and its investors by advocating for sound industry practices and public policies that foster efficient, transparent, and fair capital markets. MFA, based in Washington, DC, is an advocacy, education, and communications organization established to enable hedge fund and managed futures firms in the alternative investment industry to participate in public policy discourse, share best practices and learn from peers, and communicate the industry's contributions to the global economy. MFA members help pension plans, university endowments, charitable organizations, qualified individuals and other institutional investors to diversify their investments, manage risk, and generate attractive returns. MFA has cultivated a global membership and actively engages with regulators and policy makers in Asia, Europe, North and South America, and many other regions where MFA members are market participants